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Report
No. 98-432

TAX REFORM ACT OF 1983

REPORT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON

H.R. 4170

together with

SUPPLEMENTAL, ADDITIONAL, AND ADDITIONAL SUPPLEMENTAL VIEWS

[Including cost estimates of the Congressional Budget Office]

Volume I

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98TH CONGRESS | HOUSE OF REPRESENTATIVES | REPORT
1st Session | | No. 98-432

TAX REFORM ACT OF 1983

OCTOBER 21, 1983.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

together with

SUPPLEMENTAL, ADDITIONAL, AND ADDITIONAL SUPPLEMENTAL VIEWS

[To accompany H.R. 4170]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 4170) to provide for tax reform, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill do pass.

The amendments (stated in terms of the pages and lines of the introduced bill) are as follows:

AMENDMENTS TO TITLE IX

In the table of contents, strike out "Sec. 926." and insert in lieu thereof "Sec. 928.", and after the item relating to section 925 insert the following new items:

Sec. 926. SSI benefits for individuals who perform substantial gainful activity despite severe medical impairment.
Sec. 927. Additional functions of Advisory Council; work evaluations in case of applicants for and recipients of SSI benefits based on disability.

On page 632, after line 17, insert the following new subsection:

(c) Section 1614(a) of such Act is amended by adding at the end thereof the following new paragraph:

"(5) A recipient of benefits based on disability under this title may be determined not to be entitled to such benefits on the basis of a finding that the physical or mental impairment on the basis of which such benefits are provided has ceased, does not exist, or is not disabling only if such finding is supported by—

"(A) substantial evidence which demonstrates that there has been medical improvement in the individual's impairment or combination of impairments so that the individual is now able to engage in substantial gainful activity; or

"(B) substantial evidence (except in the case of an individual eligible to receive benefits under section 1619) which—

"(i) consists of new medical evidence and a new assessment of the individual's residual functional capacity and demonstrates that, although the individual has not improved medically, he or she is nonetheless a beneficiary of advances in medical or vocational therapy or technology so that the individual is now able to engage in substantial gainful activity, or

"(ii) demonstrates that, although the individual has not improved medically, he or she has undergone vocational therapy so that he or she is now able to engage in substantial gainful activity; or

"(C) substantial evidence which demonstrates that, as determined on the basis of new or improved diagnostic techniques or evaluations, the individual's impairment or combination of impairments is not as disabling as it was considered to be at the time of the most recent prior decision that he or she was under a disability or continued to be under a disability, and that therefore the individual is able to engage in substantial gainful activity.

Nothing in this paragraph shall be construed to require a determination that a recipient of benefits under this title based on disability is entitled to such benefits if evidence on the record at the time any prior determination of such entitlement to benefits was made, or new evidence which relates to that determination, shows that the prior determination was either clearly erroneous at the time it was made or was fraudulently obtained, or if the individual (unless he or she is eligible to receive benefits under section 1619) is engaged in substantial gainful activity. In any case in which there is not available medical evidence supporting a prior determintion of disability nothing in this paragraph shall preclude the secretary, in attempting to meet the requirements of the preceding provisions of ths paragraph from securing additional medical reports necessary to reconstruct the evidence which supported such prior determination.".

On page 633, line 1, insert "or title XVI" after "section 221".

On page 633, insert "(1) after "(a) in line 10, strike out "(b) and insert in lieu thereof "(2)" in line 20, and insert after line 21 the following new subsection:

(b) section 1614(a)(3) of such act is amended by adding at the end thereof the following new subparagraph:

"(G) In determining whether an individual's physical or mental impairment or impairments are of such severity that he or she is unable to engage in substantial gainful activity, the Secretary shall consider the combined effect of all of the individual's impairments without regard to whether any such impairment, if considered separately, would be of such severity.".

On page 635, line 1, after "section 221(h) of the Social Security Act (as redesignated by section 914(1) of this Act)", insert the following: ", or under the corresponding requirements established for disability determinations and reviews under title XVI of such Act,".

On page 635, line 15, strike out "under section 221(h) of such Act (as so redesignated)".

On page 635, line 22, after "individual" insert "(other than an individual eligible to receive benefits under section 1619 of the Social Security Act)".

On page 636, in lines 4, 9, and 25, insert "or XVI" after "title II".

On page 643, line 2, after "(as amended by this section))" insert ", and determinations under the corresponding requirements established for disability determinations and reviews under title XVI of such Act,".

On page 644, strike out "(b)" and insert in lieu thereof "(c)" in line 18, and insert after line 17 the following new subsection:

(b) Section 1631(a) of such Act is amended by adding at the end thereof the following new paragraph:

"(7)(A) In any case where—

"(i) an individual is a recipient of benefits based on disability or blindness under this title,

"(ii) the physical or mental impairment on the basis of which such benefits are payable is found to have ceased, not to have existed, or to no longer be disabling, and as a consequence such individual is determined not to be entitled to such benefits, and

"(iii) a timely request for review or for a hearing is pending with respect to the determination that he is not so entitled,

such individual may elect (in such manner and form and within such time as the Secretary shall by regulations prescribe) to have the payment of such benefits continued for an additional period beginning with the first month beginning after the date of the enactment of this paragraph for which (under such determination) such benefits are no longer otherwise payable, and ending with the earlier of (I) the month preceding the month in which a decision is made after such a hearing, or (II) the month preceding the month in which no such request for review or a hearing is pending.

"(B)(i) If an individual elects to have the payment of his benefits continued for an additional period under subparagraph (A), and the final decision of the Secretary affirms the determination that he is not entitled to such benefits, any benefits paid under this title pursuant to such election (for months in such additional period) shall be considered overpayments for all purposes of this title, except as otherwise provided in clause (ii).

"(ii) If the Secretary determines that the individual's appeal of his termination of benefits was made in good faith, all of the benefits paid pursuant to such individual's election under subparagraph (A) shall be subject to waiver consideration under the provisions of subsection (b)(1).

"(C) The provisions of subparagraphs (A) and (B) shall apply with respect to determinations (that individuals are not entitled to benefits) which are made on or after the date of the enactment of this paragraph, or prior to such date but only on the basis of a timely request for review or for a hearing.".

On page 647, insert "(a)" before "Section" in line 4, and insert after line 21 the following new subsection:

(b) Section 1631(d)(1) of such Act is amended by inserting "(b)(2)," after "(a),".

On page 649, after line 5, insert the following new subsection:

(b) Section 1633 of such Act is amended by adding at the end thereof the following new subsection:

"(c) Section 234 shall apply with respect to decisions of United States courts of appeals involving interpretations of provisions of this title or of regulations prescribed under this title (and requiring action with respect to such provisions) in the same manner and to the same extent as it applies with respect to decisions involving interpreations of provisions of title II or of regulations prescribed thereunder (and requiring action with respect to such provisions).".

On page 649, line 6, strike out "(b) The amendment made by subsection (a)" and insert in lieu thereof "(c) The amendments made by subsections (a) and (b)".

On page 650, strike out "(c)" and insert in lieu thereof "(d)" in line 16, and insert after line 15 the following new subsection:

(c) The first sentence of section 1615(d) of such Act is amended by striking out "if such services result in their performance of substantial gainful activity which lasts for a continuous period of nine months" and inserting in lieu thereof the following: "(1) in cases where the furnishing of such services results in the performance by such individuals of substantial gainful activity for continuous periods of nine months, (2) in cases where such individuals are determined to be no longer entitled to benefits under this title because the physical or mental impairments on which the benefits are based have ceased, do not exist, or are not disabling (and no reimbursement under this subsection shall be made for services furnished to any individual receiving such benefits for any period after the close of such individual's ninth consecutive month of substantial gainful activity or the close of the month with which his or her entitlement to such benefits ceases, whichever first occurs), and (3) in cases where such individuals, without good cause, refuse to accept vocational rehabilitation services or fail to cooperate in such a manner as to preclude their successful rehabilitation".

On page 650, line 18, after "section 225(b) of the Social Security Act" insert the following: "(or who are determined to be no longer entitled to benefits under title XVI of such Act because the physical or mental impairments on which the benefits are based have ceased, do not exist, or are not disabling)".

On page 652, lines 14 and 15, strike out "and procedures," and insert in lieu thereof "and procedures under titles II and XVI of the Social Security Act,".

On page 653, after and below line 2, insert the following new sentence:

The Council shall also have the functions and responsibilities (with respect to work evaluations in the case of applicants for and recipients of benefits based on disability under title XVI) which are set forth in section 307 of this Act.

On page 653, line 22, after "under title II" insert "and the program of benefits for the blind and disabled under title XVI".

On page 654, line 15, strike out "section 205(b) or 221(d)" and insert in lieu thereof "section 205(b), 221(d), or 1631(c)".

On page 655, after line 9, insert the following new sections:

SSI BENEFITS FOR INDIVIDUALS WHO PERFORM SUBSTANTIAL GAINFUL ACTIVITY DESPITE SEVERE MEDICAL IMPAIRMENT

SEC. 306. (a) Section 201(d) of the Social Security Disability Amendments of 1980 is amended by striking out "shall remain in effect only for a period of three years after such effective date" and inserting in lieu thereof "shall remain in effect only through June 30, 1986".

(b) Section 1619 of the Social Security Act is amended by adding at the end thereof the following new subsection;

"(c) The Secretary of Health and Human Services and the Secretary of Education shall jointly develop and disseminate information, and establish training programs for staff personnel, with respect to the potential availability of benefits and services for disabled individuals under the provisions of this section. The Secretary of Health and Human Services shall provide such information to individuals who are applicants for and recipients of benefits based on disability under this title and shall conduct such programs for the staffs of the District offices of the Social Security Administration. The Secretary of Education shall conduct such programs for the staffs of the State Vocational Rehabilitation agencies, and in cooperation with such agencies shall also provide such information to other appropriate individuals and to public and private organizations and agencies which are concerned with rehabilitation and social services or which represent the disabled.".

ADDITIONAL FUNCTIONS OF ADVISORY COUNCIL; WORK EVALUATIONS IN CASE OF APPLICANTS FOR AND RECIPIENTS OF SSI BENEFITS BASED ON DISABILITY

SEC. 307. The functions and responsibilities of the Advisory Council on the Medical Aspects of Disability (established by section 304 of this Act) shall include—

(1) a consideration of alternative approaches to work evaluation in the case of applicants for benefits based on disability under title XVI and recipients of such benefits undergoing reviews of their cases, including immediate referral of any such applicant or recipient to a vocational rehabilitation agency for services at the same time he or she is referred to the appropriate State agency for a disability determination;

(2) an examination of the feasibility and appropriateness of providing work evaluation stipends for applicants for and recipients of benefits based on disability under title XVI in cases where extended work evaluation is needed prior to the final determination of their eligibility for such benefits or for further rehabilitation and related services;

(3) a review of the standards, policies, and procedures which are applied or used by the Secretary of Health and Human Services with respect to work evaluations, in order to determine whether such standards, policies, and procedures will provide appropriate screening criteria for work evaluation referrals in the case of applicants for and recipients of benefits based on disability under title XVI; and

(4) an examination of possible criteria for assessing the probability that an applicant for or recipient of benefits based on disability under title XVI will benefit from rehabilitation services, taking into consideration not only whether the individual involved will be able after rehabilitation to engage in substantial gainful activity but also whether rehabilitation services can reasonably be expected to improve the individual's functioning so that he or she will be able to live independently or work in a sheltered environment.

For purposes of this section, "work evaluation" includes (with respect to any individual) a determination of (A) such individual's skills, (B) the work activities or types of work activity for which such individual's skills are insufficient or inadequate, (C) the work activities or types of work activity for which such individual might potentially be trained or rehabilitated, (D) the length of time for which such individual is capable of sustaining work (including, in the case of the mentally impaired, the ability to cope with the stress of competitive work), and (E) any modifications which may be necessary, in work activities for which such individual might be trained or rehabilitated, in order to enable him or her to perform such activities.

On page 655, line 10, strike out "Sec. 926." and insert in lieu thereof "Sec. 928."

AMENDMENT TO TITLE X

Page 667, after line 13, insert the following new section (and insert a corresponding item in the table of sections to title X):

PAYMENT FOR PHYSICIANS' SERVICES FURNISHED TO HOSPITAL INPATIENTS

Sec. 1007. (a) Subsection (b) of section 1842 of the Social Security Act (42 U.S.C. 1395u) is amended by redesignating paragraphs (4) through (6) as paragraphs (5) through (7), respectively, and by inserting after paragraph (3) the following new paragraph:

"(4)(A) In determining the prevailing charge levels under the third and fourth sentences of paragraph (3) for physicians' services furnished to inpatients of a hospital, the Secretary shall not set any level higher than the same level as was set for the period ending June 30, 1983, in the case of that portion of the period ending June 30, 1984, which occurs after December 31, 1983.

"(B) In determining the prevailing charge levels under the third and fourth sentences of paragraph (3) for physicians' services furnished to inpatients of a hospital for periods beginning after June 30, 1984, the Secretary shall treat the levels as set under subparagraph (A) as having fully provided for economic changes which would have been taken into account but for the limitations contained in subparagraph (A).".

(b)(1) Section 1866(a)(1) of such Act (42 U.S.C. 1395cc(a)(1)) is amended by striking out "Any provider" and inserting in lieu thereof "Subject to paragraph (4), any provider".

(2) Section 1866(a) of such Act is further amended by inserting at the end the following new paragraph:

"(4)(A) A hospital shall be qualified to participate under this title and shall be eligible for payments under this title only if it provides (in the agreement filed with the Secretary under paragraph (1)) that any physician who—

"(i) is on the medical staff of the hospital (courtesy or otherwise) and

"(ii) furnishes services to inpatients in the hospital,

must enter into an agreement described in subparagraph (B) in a manner established by the Secretary.

"(B) A physician's agreement referred to in subparagraph (A) is an agreement by the physician not to impose any charge or receive payment for any services which are furnished to any inpatient in the hospital for which payment may be made under part B except on the basis of an assignment in section 1842(b)(3)(B)(ii) or under the procedure described in section 1870(f)(1).".

(3) Section 1866(b)(2) of such Act is amended by inserting before the period at the end thereof the following: ", or (H) that such provider (in the case of a hospital) is not complying with the provisions of the agreement specified in subsection (a)(4)".

(c)(1) The amendments made by subsection (a) shall be effective with respect to items and services furnished on or after January 1, 1984.

(2) The amendments made by subsection (b) shall only apply to physicians' services furnished during the period beginning on January 1, 1984, and ending six months after the date the Congress receives the report of the Secretary of Health and Human Services under section 603(a)(2)(B) of the Social Security Amendments of 1983 (relating to a report on including payment for physicians' services to hospital inpatients in the DRG-based payment amount to hospitals).

(3) The Secretary of Health and Human Services shall provide for notice to individuals enrolled (or enrolling) under the supplementary medical insurance program under part B of title XVIII of the Social Security Act of the amendments made by subsection (b).

I. OVERVIEW AND BACKGROUND

A. Overview

The Tax Reform Act of 1983 (H.R. 4170), as reported by the Committee on Ways and Means, provides for the simplification, improvement, and revision of major portions of the present tax system. Likewise, it provides for the improvement of the Social Security disability system and the medicare system. Although the main purpose of the bill is reform and simplification, the overall revenue effect of the bill is to increase revenues by $2.31 billion in fiscal year 1984, $2.33 billion in fiscal year 1985, and $3.43 billion in fiscal year 1986.

The principal provisions of the bill are as follows:

- A reduction in the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities.
- Replacement of the existing three-phase structure of taxation of life insurance companies by a simpler single-phase tax, more like that imposed on corporations in other industries.
- Adoption of a permanent definition of life insurance contracts.
- Revision of the IRA rules to allow additional nondeductible contributions of up to $1,750 per year per taxpayer.
- Modifications of rules, principally enacted in the Tax Reform Act of 1969, for the tax treatment of private foundations and charitable contributions to foundations.
- Revision of the penalty for failure by an individual to pay estimated income tax, and a new requirement to make estimated tax payments of the alternative minimum tax.
- Simplification of domestic relations rules, designed to clarify the tax consequences of cash and property transfers in connection with divorce, and to provide relief of liability for an innocent spouse in certain cases.
- Revision of the at-risk rules to reduce the base for the investment tax credit by nonrecourse indebtedness related to the property, and to exempt from all at-risk rules the active trade or business activities of a regular business corporation.
- Estate tax revisions, including permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests, and a limitation on the alternate valuation date election.
- Standards for determining whether an alien individual is a resident of the United States.
- Clarification of foreign personal holding company attribution rules and taxing rules.
- Prevention of double taxation and double crediting of foreign income taxes when a U.S. owner of a controlled foreign corporation disposes of his shares or liquidates the corporation.

- Coordination of subpart F with the foreign personal holding company provisions.
- Treatment of a foreign corporation as domestic if the foreign and domestic corporations are stapled entities, and treatment of two domestic corporations that are stapled together as each owning the other.
- A series of changes to simplify and improve certain Treasury administrative provisions and the Tax Court provisions.
- Grouping of income tax credits into a more logical order, and more uniform rules for tax liability limitations and carryovers.
- Permission to roll over certain partial distributions from qualified plans.
- An expansion of the definition of related parties and an amendment to the 2½-month rule to allow the deduction of expenses whenever payment is made to a related party.
- An extension of the loss rules on small business stock to include preferred stock of qualified small business corporations.
- A medical care deduction for lodging expenses while away home, in certain cases.
- Exclusions from income and employment taxes for certain fringe benefits, generally where an employer makes its products or services are available to employees on a nondiscriminatory basis.
- Technical corrections to tax legislation enacted in 1982 and 1983.
- An extension of authority to issue mortgage subsidy bonds for an additional 5 years.
- An election to States and localities to trade in their authority to issue mortgage subsidy bonds for authority to issue tax credits to the same persons eligible for mortgage subsidy bonds.
- Imposition of a $150 per capita annual volume cap on the amount of tax-exempt industrial development bonds and student loan bonds that States and localities can issue.
- Reduction of accelerated cost recovery deductions for certain facilities financed with IDBs and the imposition of other restrictions limiting the use of IDBs.
- An election to treat as capital gain a portion of the gain from the sale of property that has been converted into condominium units, and rules to insure that a corporation cannot be used to avoid ordinary income treatment on the sale of converted condominiums to customers.
- A casualty loss deduction for property rendered unsafe by a mudslide or other disaster and condemned.
- Revisions of the treatment of offshore commodity funds, including the application of the accumulated earnings tax to certain earnings of a foreign corporation from U.S. investments, an extension of the foreign investment company rules to commodities transactions and an extension of the tax straddle rules to certain corporate stock.
- An exclusion from gross income of amounts deferred by an employee pursuant to a salary reduction arrangement under a money purchase plan.
- Reform of Social Security disability benefits provisions.
- Establishment of a fee schedule for clinical laboratories.

- Continuation of the existing part B premium at 25 percent of program costs.
- Coverage of hepatitis B vaccine.
- Establishment of guidelines for frequency of pacemaker monitoring.
- Limitations on payment for certain foot care.
- Temporary freeze on physician payments and mandatory assignment.
- Certain amendments to the trade adjustment assistance programs for workers and firms under the Trade Act of 1974 as amended.

B. Legislative Background

Sources of the bill

The committee bill (H.R. 4170), as ordered reported on October 20, 1983, consists of 11 titles. These 11 titles are either from bills previously ordered favorably reported by the committee or certain other provisions ordered favorably reported. Markup by the full committee on these provisions occurred on July 26–27, October 4–6, and October 18–19, 1983. Subcommittee markup dates are indicated below.

The sources of the 11 titles are as follows:

Title I—Tax-Exempt Entity Leasing Provisions.
(H.R. 3110, as amended).
Title II—Life Insurance Tax Provisions
(H.R. 4065, as amended).
Title III—Revision of Private Foundation Provisions (report and recommendations of the Oversight Subcommittee, with amendments).
Title IV—Tax Simplification Provisions
(H.R. 3475, as amended, including H.R. 3592 and H.R. 3593, as amended).
Title V—Fringe Benefit Provisions
(H.R. 3525, as amended).
Title VI—Technical Corrections
(H.R. 3805, as amended).
Title VII—Tax-Exempt Bond Provisions
(including H.R. 2504, as amended).
Title VIII—Miscellaneous Revenue Matters
(H.R. 699, H.R. 2476, H.R. 2831, H.R. 3096, and H.R. 3173, as amended).
Title IX—Social Security Disability Benefits
(H.R. 3755, as amended).
Title X—Medicare Budget Reconciliation Amendments
(recommendations from the Subcommittee on Health, as amended).
Title XI—Trade Adjustment Assistance
(certain provisions from H.R. 3391 as previously reported by the committee and passed by the House).

Committee and Subcommittee consideration of the bill

Title I—Tax-Exempt Entity Leasing Provisions

This title of the bill originated from H.R. 3110 as amended and ordered favorably reported by the committee on July 27, 1983. The bill was introduced on May 24, 1983, and the committee held a public hearing on June 8, 1983. The provisions of H.R. 3110 were marked up by the committee on July 26 and 27, 1983.

Title II—Life Insurance Tax Provisions

This title originated from H.R. 4065 as amended and ordered favorably reported by the committee on October 5, 1983. The bill was introduced on October 3, 1983, as ordered reported from the Subcommittee on Select Revenue Measures. Subcommittee markup sessions were held on a draft proposal on August 2, 1983, and September 27, 1983. Subcommittee hearings on life insurance tax proposals were held on May 10-11, 1983, and July 28, 1983.

Title III—Revision of Private Foundation Provisions

This title originated from a report and recommendations of the Subcommittee on Oversight. (See Subcommittee Report dated September 28, 1983, WMCP 98-14.) The committee marked up the Subcommittee recommendations on October 5 and 6, 1983. The Subcommittee approved its recommendations on September 14 and 15, 1983. Subcommittee hearings on the tax treatment of private foundations were held on June 27, 28, and 30, 1983.

Title IV—Tax Simplification Provisions

This title originated from H.R. 3475 as amended and ordered favorably reported by the committee on October 4, 1983. H.R. 3475 was introduced on June 30, 1983, and the committee held a public hearing on July 25, 1983.

The title also includes the provisions of H.R. 3592 and H.R. 3593 as ordered favorably reported by the committee on October 4, 1983. A public hearing was held on these bills on September 21, 1983, by the Subcommittee on Select Revenue Measures. The Subcommittee marked up and approved these bills on September 29, 1983.

Title V—Fringe Benefit Provisions

This title originated from H.R. 3525 as amended and ordered favorably reported by the committee on October 5, 1983. The bill was introduced on July 12, 1983, and a public hearing was held on August 1, 1983, by the Subcommittee on Select Revenue Measures. The Subcommittee marked up and approved the bill on September 29, 1983.

Title VI—Technical Corrections

This title originated from H.R. 3805 as amended and ordered favorably reported by the Committee on October 4, 1983. This bill was introduced on August 4, 1983, and the committee held a public hearing on September 22, 1983.

Title VII—Tax-Exempt Bond Provisions

This title was based generally on the provisions of H.R. 1635 and H.R. 1176, and these provisions as amended were approved and ordered favorably reported by the committee on October 18, 1983. H.R. 1635 was introduced on February 24, 1983, and a public hearing was held by the committee on June 15-16, 1983. H.R. 1176 was introduced on February 2, 1983, and a public hearing was held by the committee on June 15–16, 1983.

The title also includes the provisions of H.R. 2504 as amended and ordered favorably by the committee on October 4, 1983. H.R 2504 was introduced on April 12, 1983, and a public hearing was held on September 21, 1983, by the Subcommittee on Select Revenue Measures. The Subcommittee marked up the bill and approved it on September 29, 1983.

Title VIII—Miscellaneous Revenue Matters

This title originated from five miscellaneous tax bills (H.R. 699, H.R. 2476, H.R. 2831, H.R. 3096, and H.R. 3173) as amended and ordered favorably reported by the committee on October 4, 1983. These bills were marked up and approved on September 29, 1983, by the Subcommittee on Select Revenue Measures. A public hearing was held by the Subcommittee on September 21, 1983. H.R. 699 was introduced on January 6, 1983; H.R. 2476 was introduced on April 12, 1983; H.R. 2831 was introduced on April 28, 1983; H.R. 3096 was introduced on May 23, 1983; and H.R. 3173 was introduced on May 26, 1983.

Title IX—Social Security Disability Benefits

This title originated from H.R. 3755 as amended and ordered favorably reported by the committee on September 27, 1983. The bill was introduced on August 3, 1983, and the Subcommittee on Social Security marked up and approved the bill on August 3, 1983. A public hearing was held on the subject by the Subcommittee on June 30, 1983.

Title X—Medicare Budget Reconciliation Amendments

This title originated from provisions as amended and ordered favorably reported by the committee on October 19, 1983. The provisions considered by the committee were from recommendations by the Subcommittee on Health, which marked up and approved the recommendations on October 5, 1983.

Title XI—Trade Adjustment Assistance Programs

This title originated from sections 3, 6, and 8 of H.R. 3391 as previously reported by the committee on June 29, 1983. (H. Rep No. 98-281) and passed by the House on September 15, 1983. Subcommittee hearing was held on the subject on February 15, 1983.

II. SUMMARY OF THE BILL

The following is a title-by-title summary of the principal provisions of H.R. 4170 as reported by the Committee.

Title I—Tax-Exempt Entity Leasing

Present law

The Federal income tax benefits of ownership of property generally include accelerated depreciation deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used (though not owned) by a tax-exempt organization or a domestic governmental unit qualifies for accelerated cost recovery (ACRS) or other depreciation deductions but generally does not qualify for investment credits (nontaxable use restriction). For example, property used under a lease by one of those entities is ineligible for the investment credit. A statutory exception to the nontaxable use restriction provides that qualified rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service (IRS) has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States, then, in general, ACRS deductions are slowed down and no investment credit is allowed.

The bill

In general, the bill reduces the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities. Under the bill, tax-exempt entities include the United States, any State or local governmental unit, possessions of the United States, and most agencies and instrumentalities of any of the foregoing. The term also includes organizations (other than farmers' cooperatives described in section 521) exempt from United States income tax and certain organizations that were formerly exempt. The term also includes certain foreign persons or entities.

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The bill generally requires that ACRS or other depreciation deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year real property) or, in the case of property subject to a lease, 100 percent (125 percent in the case of 15-year real property) of the term of the lease. In the case of 15-year real property, this provision applies to the extent of use of a type or types specified in the bill, but only if more than 20 percent of the property is so used. Special depreciation rules are provided for certain high technology property which is tangible personal property.

The bill also provides criteria for determining whether a transaction that is structured as a service contract or other arrangement (including a partnership or other pass-through entity) should be treated as a lease for purposes of the depreciation and investment credit provisions of the bill. The rehabilitation credit will be denied for real property that is subject to the slower depreciation rules provided by the bill, but only if the rehabilitation expenditures are, or acquisition of the building to be rehabilitated is, financed in whole or in part with the proceeds of obligations the interest on which is exempt from Federal income tax under section 103(a).

The bill does not apply to property leased for a short term.

The bill generally applies to property placed in service by the taxpayer after May 23, 1983, and to property used under an agreement entered into after that date. However, three transitional rules are provided.

Title II—Life Insurance Tax Provisions

Company Taxation

Overview

In lieu of the present law three-phase pattern of taxation which applies to life insurance companies, the bill provides a new single-phase tax structure. This structure embodies the tax rules applicable to corporations generally except that certain special rules apply to address issues unique to the life insurance industry. The principal special rules include (1) a deduction for additions to life insurance reserves based on the greater of any cash value provided under a life insurance contract or a reserve for the contract computed under rules provided in the Internal Revenue Code, (2) a limitation on the deductibility of policyholder dividends and other amounts paid or credited to policyholders by a mutual company which ensures that the company is taxed at the company level on a minimum return on its equity, (3) a deduction for small life insurance companies, and (4) a generally applicable deduction which reduces the aggregate tax burden on the life insurance industry.

Under present law, life insurance companies may be taxed on different tax bases. As a consequence, different companies derive varying degrees of benefit from the various special deductions generally allowable only to life insurance companies and reserve computation rules of present law. Under the single-phase structure provided by the bill, all deductions benefit life insurance companies equally except to the extent that a company's final tax burden is affected by the special deduction for small companies or by the limitation on the deduction for amounts paid or credited to policyholders of mutual companies.

Computation of the deduction for reserves

States require life insurance companies operating in their jurisdiction to maintain reserves. These reserves, referred to as "statutory reserves" are designed to ensure the solvency of a company rather than to provide a precise measure of the company's future liabilities. In addition, under State law, a company enjoys a large margin of flexibility in computing its reserves. In contrast, under the bill, deductions for additions to reserves more closely reflect each company's liabilities to policyholders. Further, the deductions are computed on the basis of uniform rules regardless of the particular assumptions used for purposes of computing statutory reserves.

Under these rules, a life insurance company can deduct an amount equal to the excess of the higher of (1) the net surrender value of the contracts or (2) the federally prescribed reserve, over the amount of the reserve for tax purposes at the end of the prior year. For this purpose, the net surrender value is the cash value guaranteed in the contract reduced by any penalties or charges which would be imposed upon surrender. The federally prescribed reserve is the reserve computed using the method, interest rate, and mortality table set forth in the bill. These assumptions generally reflect the minimum assumptions permitted to be made under most State laws. Thus, under these rules, if a company elects to maintain for State purposes a reserve that is higher than both the current liability of the company to the policyholder and the minimum reserve which the States generally would find to be adequate, then the excess is treated as a voluntary reserve rather than a proper measure of liabilities. No deductions are allowed for voluntary reserves, or for contingency reserves or special reserves on nonparticipating policies, accident and health insurance contracts, or group life insurance contracts. Similarly, because under the bill reserves are generally computed on a preliminary term basis, no revaluation of reserves for tax purposes from preliminary term to net level premium is permitted.

Limitation on mutual company deductions

A mutual life insurance company is owned by its policyholders. These policyholders receive distributions from the company which may represent price reductions or other policyholder benefits, interest, or returns on the policyholders' investment in the enterprise.[1] The bill allows a full deduction for amounts paid by a mutual company to policyholders in their capacity as customers.

Under the bill, amounts distributed by a mutual company to policyholders are, in effect, fragmented and no deduction is allowed at the company level for amounts distributed to policyholders in their capacity as owners of the company. This is accomplished by means of an ownership differential provision. Under this provision, each mutual company's deductions for payments and credits to policyholders are reduced by the amount of an imputed return on the company's equity.

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[1] In contrast, a stock life insurance company is owned by shareholders. Although a stock company may pay policyholder dividends to its policyholders, such amounts would generally include only price reductions and policyholder benefits.

The equity of a mutual life insurance company is the excess of assets over liabilities as shown on the annual statement required under State law, except that assets are increased by the amount of any nonadmitted financial (investment) assets, and liabilities are adjusted (1) to reflect the Federal tax computation of reserves described above, (2) to eliminate any reserve for securities valuation, and (3) to eliminate one-half of any provision for policyholder dividends.

The bill also mandates a study in which the Treasury would analyze the operation of this provision in its first 3 years. The study would identify taxes paid in each year by stock and mutual life companies, review other relevant data, and consider the relevance and impact of taxes paid by shareholders of stock life companies on dividend distributions. The study is intended to provide Congress with the data necessary to analyze the propriety of this ownership differential provision in general and, in particular, of the relative Federal income tax burdens of the stock and mutual segments of the life insurance industry achieved under the bill.

Stock life insurance subsidiaries of mutual companies

As a general rule, under the bill, a stock life insurance subsidiary of a mutual life insurance company is treated as a stock company for tax purposes. However, for purposes of computing the limitation on mutual company deductions, the equity of a stock subsidiary is included in the mutual parent. Further, as described below, it is necessary to determine an average mutual earnings rate in order to compute this limitation. For this purpose, a stock subsidiary of a mutual is treated as a mutual.

Special rule for small companies

Under present law, many life insurance companies, including a large number of smaller companies, achieve substantial reductions in their taxable income through the use of one or more provisions not generally applicable to other companies. The amount of the reduction in taxable income achieved through these provisions varies from company to company. Further, there does not appear to be any necessary correlation between the size of a company and its ultimate tax liability.

Under the bill, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The amount of this deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities.

A small company is one the assets of which (computed on the basis of an affiliated group including both insurance and noninsurance members) are less than $500 million.

Rate reduction

All life insurance companies are allowed a deduction equal to 25 percent of their otherwise taxable income. This deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities.

Tax-exempt income

Under present law, liabilities to policyholders are treated as funded proportionately out of taxable and tax-exempt income. This is accomplished by allocating each item of a company's income to the company (the company's share) and to the policyholders (the policyholders' share). In general, the policyholders' share of an item of income is determined on the basis of the ratio of liabilities to policyholders over net investment income. The bill generally continues this approach except that (1) the policyholders' liabilities include all amounts that are paid or credited to policyholders and (2) 100-percent deductible dividends received from subsidiaries are no longer subject to proration unless such dividends would be subject to proration if received by the life insurance company directly. For example, a distribution from a wholly-owned subsidiary out of tax-exempt income would still be subject to proration.

Reinsurance

The present law rules with respect to reinsurance transactions between life insurance companies and other insurance companies (i.e., the denial of an interest deduction on indebtedness incurred in connection with reinsurance agreements, and the treatment of reimbursed policyholder dividends under reinsurance contracts as paid by the ceding company and not by the reinsurer) are retained. The provision under which the Treasury is granted authority to reallocate income, deductions, assets, reserves, credits, and other items in the case of related party reinsurance contracts is retained and broadened in its application.

Foreign tax credit

Under present law, different companies may have to calculate the foreign tax credit limitation on different bases. Under the single-phase approach, every company would compute its foreign tax credit limitation on the basis of the ratio of its foreign source taxable income to its worldwide taxable income. In general, every company would allocate policyholder dividends, death benefits, reserve increases, and other indirect expenses between U.S. and foreign sources in proportion to gross income.

Noncontiguous country business of mutual companies

As described above, under an ownership differential provision a mutual company is treated as earning a minimum return on its equity. For purposes of computing this amount, a mutual company that sells policies in noncontiguous countries in the Western Hemisphere reduces its equity allocable to its insurance business by the product of its total equity multiplied by a fraction which is the ratio of the reserves allocable to policies sold in such countries over total reserves.

Definition of the term life insurance company

For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees are not to be treated as insurance reserves.

Effective date

Generally, the effective date for provisions dealing with the taxation of life insurance companies is January 1, 1984. Income that would otherwise result from recomputation of reserves at the beginning of 1984 is forgiven under the bill (including section 818(c) recomputations and statutory-to-tax recomputations). Similarly, the change from present law in the bill with respect to accrual accounting for policyholder dividends will not be treated as a change in method of accounting and will not give rise to income.

The amount of deferred gain from operations held in the policyholder surplus account of the company (the Phase III account) would be frozen at its 1983 year-end level and distributions from such account would be taxed when distributed under the present law rules which are retained.

Life Insurance Products

Definition of the term life insurance

Present law does not contain a definition of life insurance or of a life insurance contract. It does, however, contain temporary rules for purposes of determining whether benefits paid under certain flexible premium products qualify as life insurance benefits exempt from income tax.

A definition of a life insurance contract is provided under the bill. Under this definition, which is based on the temporary rules contained in present law, a contract is treated as a life insurance contract if it meets (1) a "cash value accumulation" test (2) a "guideline premium" test and a "cash value corridor" test. Under the cash value accumulation test a contract qualifies if the cash value accumulated under the contract does not exceed the cash value which would arise in a traditional whole life policy assuming a reasonable interest rate is used in computing cash value. Under the guideline premium test contracts are disqualified if the amount of the policyholder's investment in the contract exceeds a traditional level of investment. The cash value corridor test disqualifies contracts which build up excessive amounts of cash value relative to life insurance risk. Special transitional rules apply to existing contracts and contracts that may be issued in 1984.

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (i.e., the difference between the face amount and the cash surrender value) will be treated as term life insurance. The cash surrender value will be treated as a deposit fund and income earned on the fund will be taxed currently.

Annuities

Under present law, cash withdrawals from a deferred annuity prior to the annuity starting date are generally included in income to the extent that the cash value of the contract exceeds the taxpayer's investment in the contract. A penalty tax is imposed on amounts included in income, except to the extent such amounts are allocable to investments made more than ten years prior to the date of the distribution.

Under the bill, the present law 10-year investment exception from the 5-percent penalty is repealed. Thus, the penalty generally will apply to distributions prior to age 59½. In addition, if the owner of a deferred annuity dies prior to annuitization, the income in the annuity will be included in the decedent's last income tax return.

Group-term life insurance

The antidiscrimination rules and the limitation on the exclusion from income of premiums for group-term benefits are extended to retired employees. These rules would not apply to coverage in place under existing group plans on September 27, 1983.

Policyholder loans

Under the bill, the deduction for businesses for interest incurred on a loan from a policy insuring the life of a qualified individual would be limited to an amount equal to the product of $500,000 multiplied by the deficiency rate prescribed under section 6621. For nonbusiness loans, the deduction is limited to interest on loans not greater than the product of $500,000 multiplied by the section 6621 deficiency rate for taxpayers filing a joint return ($250,000 for single taxpayers). The bill contains carryover rules for unused deduction limitation. The new rules generally are effective for policies issued after September 27, 1983.

Nondeductible Contributions to Individual Retirement Plans

Under present law, an individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity or used to purchase retirement bonds (IRAs). The maximum amount that can be contributed is limited. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA. An annual 6-percent excise tax applies to prohibited nondeductible contributions (*i.e.*, excess contributions) held in an IRA. Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) are not treated as excess contributions subject to the six percent annual excise tax. The nondeductible limit may not exceed $1,750.

The provision is effective for taxable years beginning after December 31, 1983.

Title III—Revision of Private Foundation Provisions

Charitable deduction rules

Under present law, contributions by individuals of cash or property to private nonoperating foundations (and certain other charitable organizations) generally are deductible up to 20 percent of the donor's adjusted gross income (Code sec. 170(b)(1)(B)). The bill raises this limitation to 30 percent for gifts of cash and ordinary-income property, but retains the 20-percent limitation for all gifts of capital-gain property other than to public charities or private operating foundations.

The bill also provides that contributions to private nonoperating foundations of certain appreciated stock are deductible at the stock's fair market value (rather than at the present-law limitation of the donor's basis plus 60 percent of the appreciation). The increased deduction applies only to the extent that the cumulative total of donations by a donor (and family members) to private nonoperating foundations of stock in a particular corporation is less than 10 percent of the value of all outstanding stock of that corporation.

In addition, the bill extends to private nonoperating foundations the same rules on carryovers of charitable contributions exceeding the percentage limitations as apply under present law for contributions by individuals to public charities and private operating foundations (sec. 170(d)).

These changes made by the bill apply to contributions made after 1983. The increased deduction for contributions of certain appreciated stock will not apply to contributions made after 1993.

Excise tax on investment income

The bill reduces from two to one percent the rate of the excise tax on net investment income of private foundations (sec. 4940), effective for post-1983 taxable years, but only if the foundation's payout for charitable purposes (computed as a five-year average) is increased by an equivalent amount.

Also, the bill exempts from the section 4940 excise tax any private operating foundation that previously had been publicly supported for at least 10 years (or was in existence on January 1, 1983), that has a governing body broadly representative of the general public (with at least 75 percent consisting of persons unrelated to the foundation), and none of whose officers otherwise are disqualified persons. This amendment applies to post-1983 taxable years.

Mandatory payout rules

The bill limits the amount of grant administrative expenses which may be counted as qualifying distributions for purposes of meeting the minimum payout requirement (sec. 4942), effective for post-1983 taxable years, to 15 percent of the amount of grants, gifts, and contributions made by the foundation, computed on the basis of a five-year average. The limitation does not apply to administrative expenses incurred directly for the active conduct of an exempt activity.

Divestiture of excess business holdings

The bill generally retains the divestiture rules of present law (sec. 4943) with respect to "grandfathered" excess business holdings which were held by private foundations on May 26, 1969, with certain modifications.

In the case of an unusually large gift or bequest after 1969 of diverse or complex excess business holdings, the bill provides the Internal Revenue Service with discretionary authority to permit an additional five-year period for divestiture on a showing by the foundation of good cause plus diligent efforts to dispose of the holdings within the five-year period permitted under present law.

Expenditure responsibility and reliance rules

The bill exempts from the expenditure responsibility requirements imposed on foundation grantors (sec. 4945) grants to those private operating foundations which the bill exempts from the two-percent excise tax on net investment income (see above), effective for post-1983 taxable years.

The Treasury Department is to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. Also, Treasury regulations are to be amended to extend to five years the advance ruling period during which qualifying new organizations are considered public charities, and to permit greater reliance on IRS classifications of new charitable organizations in the first five years of their existence.

Foundation support for voter registration drives

The bill retains all requirements of present law limiting private foundation support for voter registration drives (sec. 4945(f)) except the requirement that the voter registration drive must be conducted in five or more States; the latter requirement is repealed effective January 1, 1984. As under present law, the registration drive must be nonpartisan, and cannot be confined to one election period.

Abatement of first-tier penalty taxes

The bill provides the Internal Revenue Service with discretionary authority to abate the automatic first-tier penalty taxes (other than the sec. 4941 tax on self-dealing) if the foundation establishes that the violation was due to reasonable cause and not to willful neglect, and corrects the violation. This provision applies to taxable events occurring after 1983.

Definitions

The bill provides that the lineal descendants who are considered members of the family of a substantial contributor or other disqualified person, and thus themselves are considered to be disqualified persons (sec. 4946), are limited to the individual's children, grandchildren, great-grandchildren, and their spouses, effective January 1, 1984.

In addition, the bill provides rules under which a person's status as a substantial contributor (sec. 507(d)) terminates in certain circumstances after 10 years with no connection to the foundation, effective for post-1983 taxable years. Also, the bill provides special retroactive relief from the excise tax on self-dealing in a particular case where continued status as a disqualified person had triggered tax on a 1978 transaction, provided that the foundation received fair market value.

Public disclosure requirements

The bill provides that, beginning in 1984, private foundation notices which must be published annually in a newspaper (sec. 6104(d)) are to include the telephone number of the foundation's principal office. Also, the Internal Revenue Service is directed to enforce fully the present-law rules concerning Form 990-PF information returns.

Games of chance

The bill exempts from the unrelated business income tax (sec. 513) income derived by nonprofit organizations from conducting certain games of chance, provided that State or local law as of October 5, 1983, permits such games to be conducted only by nonprofit organizations. This provision applies retroactively to games of chance conducted after June 30, 1981.

Title IV—Tax Simplification Provisions

Estimated Income Tax for Individuals

The individual estimated income tax rules of present law are simplified and clarified by the bill. Generally, an individual will be required to make estimated tax payments (including withholding payments) equal to the lesser of 80 percent of the current year's tax or 100 percent of the prior year's tax; penalties will be based on the underpayment from this amount. Payments based on annualized income will be allowed. The Secretary may waive the penalty for failure to make payments by reason of a casualty, disaster or other unusual circumstance where it would be inequitable to impose the penalty. Estimated tax payments of the alternative minimum tax will be required.

The provision will be effective for taxable years beginning after 1983.

Domestic Relations

Transfers of property between spouses or incident to divorce

Under present law, gain is recognized on certain transfers of property in exchange for marital rights of a spouse or former spouse. The bill provides that property transfers between spouses or, if incident to divorce, between former spouses, will not result in the recognition of gain or loss. The transferee will hold the property at the transferor's basis.

The provision will generally be effective for transfers after the date of enactment of the bill.

Alimony

Under present law, alimony is deductible by the payor and includible in the income of the payee. The bill revises the rules relating to the definition of alimony. Generally, only cash payments that will terminate on the death of the payee spouse will qualify as alimony. The present law requirement that the payment be based on a legal support obligation will be repealed. Payors will be required to furnish to the IRS the social security number of the payee spouse. A $50 penalty for failure to do so will be imposed.

The provision will generally be effective for divorce or separation agreements or orders executed after 1983.

Dependency exemption

The bill provides that the $1,000 dependency exemption for a child of divorced or separated parents generally will be allocated to the custodial parent unless the custodial parent signs a written declaration that he or she will not claim the exemption for the year. Each parent may claim the medical expenses that he or she pays for the child, for purposes of computing the medical deduction.

Income from certain sheltered workshops will not be taken into account in determining the dependency exemption.

The provision will be effective for taxable years beginning after 1983.

Innocent spouse relieved of liability in certain cases

Under present law, a spouse may be relieved of liability where he or she signs a joint return and there was a substantial omission of income attributable to the other spouse. The bill extends these rules to situations involving claims of grossly erroneous deductions and credits and would replace the substantial omission of income test with a substantial understatement of tax test. Also, the bill overrides community property laws in certain situations where it is equitable to do so.

Estate tax treatment of certain property settlements

The bill conforms the estate tax treatment with respect to transfers of property to a former spouse under certain property settlements with the present law allowing a gift tax deduction for such transfers. The provision will apply to estates of decedents dying after date of enactment of the bill.

At-risk Rules

The bill amends the at-risk limitation on the investment tax credit by providing that the base for the credit will be reduced by nonrecourse indebtedness related to the property (i.e., a loan on which there is no personal liability). Qualified commercial financing, defined as financing from an unrelated party regularly engaged in commercial lending where no more than 80 percent of all financing for the property is nonrecourse, will be excluded from the limitation. In the case of an S corporation, recourse financing at the corporate level that is provided by a qualified commercial lender will be considered recourse financing at the shareholder level if the debt is related to property used by the corporation in an active trade or business with at least 3 full-time non-owner employees.

The bill will exempt, from both the loss limitation rules of section 465 and the investment tax credit at-risk rules, the active trade or business activities of a regular business corporation. To qualify, a trade or business must have 3 full-time non-owner employees and its out-of-pocket expenses must exceed 15 percent of gross income.

The bill also requires that, in order for a lessee to be eligible to claim the full investment tax credit, the lessee must be at risk for at least 30 percent of the fair market value of the property.

The investment tax credit provisions generally will generally apply to property placed in service in taxable years ending after the date of enactment of the bill. The changes to the section 465 rules will apply to taxable years beginning after December 31, 1983.

Estate Tax Revisions

Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests

Under the rules adopted by the Tax Reform Act of 1969, a charitable interest in a split-interest trust (i.e., a trust which is part charitable and part noncharitable) must be in certain specified forms to be deductible for Federal income, gift, and estate tax purposes. Present law permits defective governing instruments of charitable split-interest trusts which were created pursuant to wills executed before January 1, 1979, to be amended to conform to the 1969 Act rules by December 31, 1981.

The bill provides a permanent rule permitting reformation of governing instruments of charitable split-interest trusts which do not meet the requirements of the 1969 Act rules where the instrument evidences an intent to comply with the 1969 Act rules and the actuarial values and durations of the charitable and noncharitable interests in the trust generally remain the same before and after the reformation.

This provision will be effective with respect to reformations made after December 31, 1978.

Alternate valuation date election

Under present law, the value of property includible in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date (which generally is six months after the decedent's death). The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. Also, under present law, the Federal income tax basis of property acquired from a decedent generally is its value for Federal estate tax purposes.

The bill provides that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are reduced by making the election. The bill would also allow the alternate valuation election to be made on the first estate tax return filed (whether filed timely or late).

This provision will be effective with respect to estates of decedents dying after the date of enactment of the bill.

Foreign Tax Provisions

Resident aliens

The bill makes several changes in the tax provisions affecting foreign income and foreign taxpayers. It provides standards for determining whether an alien individual is a resident of the United States. Under these standards, an individual who spends substantial time in the United States in any year or over a three-year period will generally be a U.S. resident. A permanent resident for immigration purposes will be a U.S. resident, also. The bill prevents married nonresident aliens from using the community property laws of their home country to split income for U.S. tax purposes.

Foreign personal holding company attribution rules

The bill clarifies the family attribution rules for determining when a foreign corporation is a foreign personal holding company. It also prevents avoidance of U.S. tax by interposition of a foreign trust or another foreign entity between a foreign personal holding company and a U.S. taxpayer.

Ordinary income treatment under section 1248

The bill clarifies the rules that tax the previously untaxed earnings and profits of a controlled foreign corporation at ordinary income rates when its U.S. owner disposes of the shares or liquidates the corporation. It will prevent later double taxation of those earnings and profits and double crediting of associated foreign taxes. It will also treat direct ownership of a controlled foreign corporation like indirect ownership for the purpose of these rules.

Coordination of subpart F with foreign personal holding company provisions

The bill coordinates the foreign personal holding company rules with the controlled foreign corporation rules. It provides that shareholders of a controlled foreign corporation (that is also a foreign personal holding company) are subject to the controlled foreign corporation rules to the extent that income taxable under those rules exceeds income taxable under the foreign personal holding company rules.

Stapled stock

The bill contains provisions regarding so-called stapled stock. It provides generally that if a foreign and a domestic corporation are stapled entities, the foreign corporation generally will be treated as domestic. In addition, if two domestic corporations are stapled entities, each will be treated as owning the other.

Miscellaneous Treasury Administrative Provisions

The bill makes a number of minor amendments relating to Treasury administrative provisions. The bill simplifies certain requirements of the Treasury Department to make reports to the Congress, removes the $1 million limitation of the Treasury working capital fund, increases the authorization limit from $1 million to $10 million on the revolving fund for the redemption of real property, allows the Secretary of the Treasury to accept gifts and bequests for the Treasury Department, allows an extension of time for court review of a jeopardy assessment where the government is not promptly served, removes the $1 million limitation on the Secretary of the Treasury's special authority to dispose of obligations, allows the Internal Revenue Service a minimum of 60 days to assess unpaid taxes shown on an amended return, provides the government a lien on the assets of all financial institutions which issue an unpaid guaranteed draft for the payment of taxes, and allows the disclosure of windfall profit tax returns to State tax agencies.

The bill also repeals the occupational tax on manufacturers of stills and condensors, allows drawback claims for distilled spirits excise taxes in certain cases, provides for disclosure of alcohol fuel producers to administrators of State alcohol laws, and repeals the stamp requirement for distilled spirits containers.

Tax Court Provisions

The bill allows certified public accountants and enrolled agents authorized to practice before the Internal Revenue Service to represent taxpayers in small claim cases before the Tax Court and increases the small claims case dollar limit from $5,000 to $10,000. The title of the Tax Court "commissioners" will be changed to "special trial judges". The bill provides that the Tax Court may prevent public disclosure of trade secrets or other confidential information. Finally, Tax Court judges will no longer be required to retire at age 70.

Simplification of Income Tax Credits

In general, the bill groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The business credits (i.e., investment tax credit, targeted jobs credit, alcohol fuels credit, and ESOP credit) will be combined into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remainder. The research credit will continue to be allowable against 100 percent of tax liability. A 3-year carryback and 15-year carryforward period on a FIFO basis will be allowed for the business and research credits.

This provision will apply to taxable years beginning after 1983.

Miscellaneous Tax Provisions

Rollover of certain partial distributions from qualified plans

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, profit-sharing, or stock bonus plan or a tax-sheltered annuity contract can be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution will be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment as prescribed by the Secretary of the Treasury.

The provision will be effective for distributions made after December 31, 1983, in taxable years ending after that date.

Treatment of certain related party transactions

The bill amends the related party rules (sec. 267) so that a taxpayer would generally be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer. These rules will be extended to amounts accrued by a partnership to its partners and vice versa.

Also, the bill extends the loss disallowance and accrual provisions to transactions between corporations which are members of a controlled group of corporations, using a 50-percent control test.

These provisions generally will apply to taxable years beginning after 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983 or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

Preferred stock eligible for small business corporation stock treatment

Under present law, a taxpayer is allowed to deduct, as an ordinary loss, up to $50,000 ($100,000 in the case of a joint return) of loss on the disposition of certain common stock of a domestic small business corporation. The bill, which applies to stock issued after the date of enactment, extends ordinary loss treatment to preferred stock of qualified small business corporations.

Medical expense deduction for certain lodging

Under present law, individuals who itemize deductions may deduct certain expenses paid for medical care to the extent the expenses exceed 5 percent of adjusted gross income. Amounts paid for transportation primarily for and essential to medical care are treated as expenses paid for medical care. Amounts paid for lodging while away from home, however, do not qualify for the deduction.

Under the bill, certain expenses for lodging while away from home to receive medical care as an outpatient at a hospital (or certain similar medical care facilities) are treated as expenses paid for medical care, up to a limit of $50 per eligible person per day. This provision is effective for taxable years beginning after 1983.

Study of gross income tax

The bill provides for a study by the Treasury Department of a simplified gross income tax, to be submitted to the Congress within 6 months after date of enactment of the bill.

Repeal of Certain Obsolete Provisions (Deadwood)

Three provisions (Code sections 405, 409, and 1251) are repealed as deadwood.

Title V—Fringe Benefit Provisions

The Code defines gross income for income tax purposes as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). Similarly, the social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding generally apply to all remuneration for employment, including noncash remuneration.

Under present law, specific statutory exclusions are provided for income and employment tax purposes for certain types of employee benefits, such as health benefits. However, the Economic Recovery Tax Act of 1981 (P.L. 97-34) extended through December 31, 1983, a moratorium on the issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits.

Under Title V of the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes. The excluded fringe benefits are those that qualify under one of the following five categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, or (5) a qualified tuition reduction. Special rules apply with respect to certain parking, or eating facilities provided to employees, on-premises athletic facilities, and demonstration use of an employer-provided car by auto salespersons.

In the case of a no-additional-cost service, a qualified employee discount, employee parking, a subsidized eating facility, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefits are also made available to other employees on a nondiscriminatory basis.

Any fringe benefit that does not qualify for exclusion under the bill or under another specific statutory provision is includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally take effect on January 1, 1984, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1984.

Title VI—Technical Corrections

This title contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983 and other recently enacted tax legislation.

Title VII—Tax-Exempt Bond Provisions

Mortgage Subsidy Bonds

Extension of qualified mortgage bond authority

The committee's bill extends the tax exemption for qualified mortgage bonds to bonds issued prior to January 1, 1989. State mortgage bond volume caps are to be reduced, in any year, by the volume of qualified veterans' mortgage bonds issued in the prior year. (An exception is provided for veterans' mortgage bonds issued pursuant to authorizations made before October 18, 1983.) Veterans' mortgage bonds would also be subject to the January 1, 1989, sunset date. Additionally, the bill makes mortgage subsidy bonds (including veterans' mortgage bonds) subject to a reporting requirement.

Mortgage credit certificates

The bill allows State and local governments, for any year, to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs will entitle homeowners to credits not exceeding 50 percent (but not less than 10 percent) of interest on indebtedness incurred with respect to qualifying residences. The credits are to be subject to the existing eligibility requirements for qualified mortgage bonds. Credits not usable in any year may be carried over against a later year's tax liability.

Under the bill, the amount of MCCs distributable by a State or local government is equal to 15 percent of the principal amount of exchanged mortgage subsidy bond authority. The amount of exchanged authority cannot exceed 9 percent of the average volume of single-family mortgages in the State during the prior three years. For States and localities which issued less than their statutory ceiling of qualified mortgage bonds in 1983, a 5-year phase-in of MCC authority is to apply.

MCCs are subject to the January 1, 1989, sunset for qualified mortgage bonds.

Limited Equity Cooperatives

The bill provides that limited equity housing cooperatives may elect to be eligible for either mortgage subsidy bond or industrial development bond (IDB) financing. If a cooperative elects to be eligible for IDB financing, the members of the cooperative may not receive deductions for interest and expenses on the property.

Industrial Development Bonds

Volume caps on private activity bonds

Under the bill, private activity tax-exempt bonds are subject to statewide volume caps. The caps are applicable to industrial development bonds (IDBs) and student loan bonds issued within the State. The caps are to be set at $150 for each resident of the State (according to the most recent census estimates). The amount of the caps will be reduced to $100 per capita after 1986 to reflect the sunset for small issue IDBs. Within each State, the cap is to be allocated among State and local issuers according to the rules for allocation of mortgage subsidy bond authority.

The bill provides for a three-year carryover of a State's volume cap to finance specific projects or for student loan bonds. The carryover is not applicable for small issue IDBs. Additionally, for States whose 1983 volume exceeds the statewide cap, a two-year phase-in is applicable.

Restrictions on cost-recovery for IDB-financed property

The bill repeals three of the four present law exceptions to the rule requiring straight-line cost recovery deductions (over ACRS periods) for IDB-financed property. However, the bill allows projects for multifamily residential rental property to receive full accelerated cost recovery over ACRS periods.

Elimination of IDBs for land or existing facilities

The bill eliminates the use of IDBs to purchase land or existing facilities in most cases. Exceptions are provided for substantial rehabilitations and for certain farms or ranches where no more than $250,000 of IDB financing is outstanding.

Restrictions on small issue IDBs

The bill allows small issue IDBS only to the extent that not more than $40 million in IDB financing is outstanding for each beneficiary of the small issue.

Under the bill, the capital expenditure limits applicable to small issue IDBs are to be applied to an entire project rather than to individual users (as under present law). For example, a multistory office building is to be treated as a single project and the limitations applied to the entire building.

The bill increases from $20 million to $25 million the size of projects receiving Urban Development Action Grants (UDAGs) which qualify for small issue IDB financing.

Federally guaranteed bonds

The bill denies a tax exemption for obligations guaranteed directly or indirectly by the Federal government, including bonds issued in connection with Federal deposit insurance. Exceptions are provided for Federal Housing Administration, Veteran's Administration, and student loan guarantees.

Non-Code tax exemptions

The bill requires bonds issued pursuant to tax exemptions outside the Internal Revenue Code to meet the requirements of the tax-exempt bond provisions of the Code, including the restrictions applicable to industrial development bonds.

Arbitrage

The bill extends the arbitrage rules applicable under present law to mortgage subsidy bonds (sec. 103A) to all private activity bonds.

Further IDB provisions

The bill denies a tax exemption where bonds are used by a principal user of the facility being financed or a partner of the principal user. The bill permits IDB financing for the multifamily rental housing portion of a mixed-use project. The bill prohibits the use of IDBs to finance liquor stores, sky boxes, private airplanes, and gambling establishments. Further, under the bill, the public approval requirements for private activity bonds are modified in the case of airports located in more than one jurisdiction.

Obligations of Certain Educational Organizations

The bill provides a tax exemption for obligations issued by the Pennsylvania State University.

Effective Dates

The provisions regarding mortgage subsidy bonds and industrial develoment bonds are generally effective for obligations issued after December 31, 1983. In the case of bonds issued in connection with Federal deposit insurance, the denial of tax exemption applies to obligations issued after April 14, 1983. The bill provides appropriate transition rules for purposes of certain of the limitations on industrial development bonds.

The provision regarding obligations at the Pennsylvania State University applies generally to obligations to which the Internal Revenue Code of 1954 is applicable.

Title VIII—Miscellaneous Revenue Matters

Capital gain treatment for portion of gain on sale of condominium units converted from existing structures

Under present law, the entire gain on the conversion of property into condominiums and the individual sale of those condominiums generally is treated as ordinary income to the seller. As a result, owners of property who wish to convert it into condominiums often sell the entire property to another person who converts the property and sells the individual condominium units. If the entire property is sold in one sale prior to conversion, the owner generally will receive capital gain treatment with respect to the gain on the sale of the property.

In general, the bill provides that a taxpayer can elect to treat a portion of the gain realized on the sale or exchange of the condominium units acquired in the conversion of qualified real property into condominium units as capital gain. The amount treated as capital gain would be the excess of the fair market value of the property over the property's adjusted basis at the time of the conversion. Any additional gain (or loss) on the disposition of the units would be treated as ordinary income (or loss). The provision would apply to conversions after the date of enactment of the bill in taxable years ending after such date.

No gain recognized from net gifts made before March 31, 1983

Present law taxes income "from whatever source derived," including the benefit resulting from the discharge of one's indebtedness by another party (Code sec. 61(a)(12)). Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Liability for the gift tax is on the donor of the transferred property.

A donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer (i.e., make a "net gift"). On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner*, that the discharge of a donor's liability for gift tax by the donee of a net gift gives rise to income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

The bill would provide that no income would be recognized to donors who made net gifts before March 4, 1981 (the date on which an initial decision by the Court of Appeals held that the donor in the *Diedrich* case recognized income).

Disaster loss deduction where taxpayer ordered to demolish or relocate residence in disaster area because of disaster

Present law allows a deduction for nonbusiness casualty losses to the extent such losses exceed $100 per loss and 10 percent of adjusted gross income for the taxable year. In general, a deduction is allowed only when the casualty (e.g., storm, flood or earthquake) causes actual physical damage to the taxpayer's property.

The bill provides that certain taxpayers whose residences are located in a Federally declared disaster area, and who are ordered by a State or local government to demolish or relocate their residences, may deduct any loss attributable to the disaster that caused the demolition or evacuation order as a casualty loss. The provision applies to taxpayers whose residences have been rendered unsafe for use as a residence as a proximate result of the disaster.

Foreign investment companies

Offshore commodity funds

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate.

The bill would, in certain cases, apply the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through corporate solution as dividends or interest. It would also generally treat gains of U.S. shareholders from those investments as ordinary income.

Corporations formed to straddle

Taxpayers may attempt to avoid the tax straddle rules by forming corporations, typically foreign corporations, to take positions to offset their own. The bill would treat such stock ownership as a position for the purposes of the straddle rules. This treatment would prevent a taxpayer from recognizing losses when the taxpayer uses a corporation for straddling purposes.

Application of cash or deferred arrangement rules to pre-ERISA money purchase plans

The Employee Retirement Income Security Act of 1974 (ERISA) provided that amounts deferred by an employee pursuant to a cash or deferred arrangement or a salary reduction arrangement under a tax-qualified profit-sharing, stock bonus, or money purchase pension plan are excluded from the employee's income if (1) the plan was in existence on June 27, 1974, and (2) the applicable requirements of prior law were satisfied. This tax treatment for then existing plans was preserved, pending study by the Congress of the appropriate treatment for cash or deferred and salary reduction arrangements.

Under the Revenue Act of 1978, amounts deferred by an employee after 1979 pursuant to a cash or deferred arrangement under a tax-qualified profit-sharing or stock bonus plan are excluded from the employee's income only if certain requirements added by the Act are met. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Under the bill, amounts deferred by an employee pursuant to a salary reduction arrangement under a money purchase pension plan are excluded from the employee's income if the plan was in existence on June 27, 1974, and contributions by employees and the employer do not exceed the levels permitted under the plan's contribution formula on that date. In addition, the plan must satisfy rules added by the 1978 Revenue Act with respect to employee participation and prohibited discrimination in favor of officers, shareholders, or highly compensated employees.

The bill will apply to plan years beginning after December 31, 1983. The rules in effect prior to ERISA will apply for plan years beginning after December 31, 1979, and before January 1, 1984.

Title IX—Social Security Disability Benefits/SSI

Standards of Disability

Standard of review for terminations of disability benefits (medical improvement)

Section 901 of the bill requires the continuation of benefits for those individuals whose conditions have not medically improved to the point of ability to perform SGA, with the following exceptions:

(a) benefits may be terminated if new evidence shows the beneficiary has benefited from advances in medical therapy or technology or from any vocational therapy to the point of ability to perform SGA; and

(b) benefits may be terminated if new evidence (including new diagnostic or evaluation techniques not available or used at the original determination) shows the impairment or impairments to be less severe than originally thought.

Section 901 also provides for termination of benefits whether or not the impairment has improved if the person is currently working at the substantial gainful activity (SGA) level, or if the prior determination of entitlement to benefits was either clearly erroneous at the time it was made, or was fraudulently obtained. SSA would be authorized to secure additional medical evidence to reconstruct initial decisions in cases where there is no medical evidence supporting the initial decision.

Study on evaluation of pain

Section 902 requires the Secretary, in conjunction with the National Academy of Sciences, to conduct a study concerning the questions of using subjective evidence of pain in determining whether a person is under a disability, and the state of the art of preventing, reducing or coping with pain. A report is to be submitted to the Committee on Ways and means and the Senate Committee on Finance by April 1, 1985.

Multiple impairments

Section 903 provides that in determinations of disability, the Secretary must consider the combined effect of all of an individual's impairments whether or not each or any impairment would alone be severe enough to qualify the person for benefits.

Disability Determination Process

Temporary moratorium on mental improvement reviews

Section 904 provides for a temporary delay on reviews of all mental impairment disabilities until the listings for mental impairments have been revised in consultation with the Advisory Council, and are published in final form in regulations. Regulations must be published no later than 9 months after the date of enactment. The delay also would be imposed on review of all CDI mental impairment cases after June 7, 1983.

Face-to-face evidentiary hearing

Section 905 provides for the implementation, no later than January 1, 1985, of face-to-face evidentiary interviews at the State agency level for medical termination cases. Under this provision, the State agency would send the beneficiary a preliminary notice of an unfavorable decision and the claimant would have 30 days in which to request a face-to-face meeting before a formal determination is made. The reconsideration level would be abolished for all initial CDI decisions completed after January 1, 1985.

Section 905 also requires the Secretary to initiate demonstration projects with respect to face-to-face evidentiary meetings at the initial level of State agency determination for new applicants and report to the Congress by April 1, 1984, and projects begun no later than July 1, 1984.

Payments of benefits during appeal

Section 906 provides on a permanent basis for the continuation of benefits during appeal in all CDI cases through the decision of the Administrative Law Judge. Where the ALJ's decision is adverse to the beneficiary, such benefit payments would be subject to recoupment as under present law. The provision also requires the Secretary to report to Congress on the impact of the provision by July 1, 1986.

Qualifications of medical professionals

Section 907 provides that no determination that a person is not under a disability be made with respect to mental impairments until a psychiatrist or psychologist employed by the State agency has completed the medical portion of the case review as well as the assessment of residual functional capacity.

Consultative examinations

Section 908 provides that regulations be promulgated regarding consultative examinations.

Miscellaneous Provisions

Application of uniform standards for disability determinations

Section 909 provides that the notice and comment provisions of Section 553 of the Administrative Procedures Act would apply to benefit programs under Title II. The provision leaves in place the existing exceptions in Section 553 of the APA referring to the issuance of interpretive rulings, as well as purely administrative procedures.

SSA compliance with certain Federal court decisions

Section 910 requires SSA to either apply the decisions of circuit courts of appeal to at least all beneficiaries residing within States within the circuit, or appeal the decision to the Supreme Court. This provision applies to circuit court opinions issued after the date of enactment as well as to those opinions which the Secretary still has the opportunity to appeal to the Supreme Court as of the date of enactment.

Payment from trust funds for costs of rehabilitation services

Section 911 repeals the requirement in those cases where there is a medical recovery that a disabled beneficiary must perform 9 months of SGA to qualify the vocational rehabilitation provider for reimbursement. In addition, payment for services to VR providers would be authorized for beneficiaries who without good cause refuse to continue to accept services or fail to cooperate with the rehabilitation process.

Advisory Council on Medical Aspects of Disability

Section 912 creates an Advisory Council on Medical Aspects of Disability composed of independent medical and vocational experts to provide advice and recommendations to the Secretary on disability standards, policies and procedures. The Council would include 10 members to be appointed by the Secretary (with the Commissioner of Social Security an ex officio member) and must include at least one psychiatrist, one rehabilitation psychologist and one medical social worker.

The Council would be authorized to periodically convene a larger representative group to assure the input of appropriate professional and consumer organizations, and would also be authorized to set up temporary short-term task forces to examine some specialized issues.

Section 912 further provides that the Council must be appointed no later than 60 days after the enactment (to assure the timely participation of the Council in the review of the mental impairment listings) and would expire on December 31, 1985.

Staff attorneys

Section 913 requires the Secretary of HHS to establish higher grade attorney positions to enable staff attorneys to achieve qualifying experience necessary to be appointed to ALJ positions.

Effective Date

Except as otherwise provided, these provisions will apply with respect to cases involving disability determinations pending in HHS or in court on or after the date of enactment.

Supplement Security Income (SSI) Disability Changes

The bill would make the same changes in the SSI disability program as the bill makes in the Social Security Disability Insurance program. In addition, the bill would extend for two and one-half years, through June 30, 1986, the temporary authority in section 1619 of the Social Security Act that provides for the continuation of SSI benefits and/or Medicaid for disabled recipients who are able to work in spite of their impairments. As related to the SSI disability program, the Advisory Council on Disability would also be required to consider alternative approaches to the use of work evaluation in determining eligibility for SSI disability benefits and to reexamine the definition of a successful rehabilitation of an SSI recipient to include the ability of the severely disabled to work in a sheltered environment and live independently.

Title X—Medicare Budget Reconciliation Amendments

Payment and coverage-related changes

Payment for outpatient diagnostic laboratory tests.—A fee schedule would be established for all clinical laboratory services provided to medicare beneficiaries except for hospital inpatients. The schedule may initially be established on a carrier or regional basis. A national fee schedule would be required to be established within three years.

The initial fee schedule would be set at a level no higher than 60 percent of prevailing charges and would be updated annually by the same percentage increase as the Consumer Price Index. The clinical laboratory would be required to bill the program directly and would be required to accept medicare assignment. For these services the laboratory would be reimbursed 100 percent of the fee schedule amount (or, if lower, the billed charge), with the deductible and coinsurance waived.

When the physician directly provides, or supervises the provision of clinical laboratory services, and where he agrees to accept medicare assignment, the physician would be reimbursed at 100 percent of the fee schedule amount (or, if lower, the billed charge) with deductible and coinsurance waived. Physicians not accepting assignment would continue to be reimbursed at 80 percent of the fee schedule amount or (if lower, 80 percent of the billed charge) with the usual deductible and coinsurance applying.

Part B premiums.—The bill would make permanent the existing temporary provision which fixes the proportion of the part B medicare costs financed by beneficiary premiums at 25 percent of program costs, effective January 1, 1986.

Coverage of hepatitis B vaccine.—Medicare would cover hepatitis B vaccine furnished to medicare patients in hospitals and renal dialysis facilities. The part B deductible and coinsurance would be waived.

Pacemaker reimbursement review and reform.—The Secretary would be required to issue guidelines on the indications for, and frequency of, transtelephonic monitoring of pacemakers. If guidelines are not established by February 1, 1984, the proposal would establish a frequency schedule for certain types of pacemakers, with exceptions for medically documented cases.

The Secretary would be required to study reimbursement rates for physicians' services with respect to pacemakers, taking into consideration changes in surgical procedures that have taken place over the years.

The FDA would establish a registry of all implanted pacemakers.

Payment for debridement of mycotic toenails.—Medicare would cover debridement of mycotic toenails no more frequently than every 60 days, unless medical necessity is documented.

Payment for costs of hospital-based mobile intensive care units.—Certain services of mobile intensive care units could be covered under medicare p[illegible] under specified circumstances in States with Statewide p[illegible] payment systems.

Freeze on physic[illegible] p[illegible]g charges; mandatory assignment

The committee ag[illegible] the following committee amendment to the committee bill:

> Prevailing c[illegible] for physicians' services provided to hospital inpatients would be frozen at the June 30, 1983 level, effective January 1, 1984 through June 30, 1984.
>
> Physicians would be required to accept medicare assignment for all services provided to medicare hospital inpatients until six months after the Congress receives the Secretary's report on including physician payments under the DRG prospective payment system, which under the bill would be due by July 1, 1985.
>
> To participate in medicare, each hospital would be required to obtain from each doctor on its medical staff an agreement to accept assignment for any medicare inpatient of the hospital.

Miscellaneous administrative changes

Presidential appointment of and pay level for the Administrator of the Health Care Financing Administration.—The bill would provide for the Presidential appointment of the Administrator of the Health Care Financing Administration with the advice and consent of the Senate. The position and pay of the Administrator would be increased to Level IV of the Executive Schedule.

Permit limited representation on peer review organizations (PRO's).—One person who is a governing body member, officer or managing employee of a health care facility would be permitted to be a member of the governing board of a PRO with less than 15 members; in the case of a PRO governing board of more than 15, two such members would be permitted.

Access to home health services.—The bill would permit a physician who has a financial interest in a home health agency that is a sole community provider to carry out the certification and plan-of-care functions for patients who receive services from the agency, and to delete from the list of disqualified physicians uncompensated officers or directors of incorporated home health agencies.

Repeal the special tuberculosis treatment requirements.—The bill would repeal the special tuberculosis requirements under medicare and medicaid.

Indirect payment of supplementary medical insurance benefits.—The bill would permit part B payments to be made to a health benefits plan whose payment is accepted by the physician or other supplier as payment in full.

Including podiatrists and dentists in the definition of "physician" for certain purposes.—A podiatrist (acting within the scope of his practice) would be considered a physician for purposes of coverage of outpatient physical therapy, which requires that the patient be "under the care of a physician." A podiatrist or a dentist (acting within the scope of his practice) would be considered a physician for purposes of coverage of outpatient ambulatory surgery in a surgeon's office.

Establishment by physical therapist of plans for physical therapy.—Either a physical therapist or a physician would be permitted to establish a plan of treatment for physical therapy services. The physician would still be required to review the plan periodically, as under existing law.

Access to records of subcontractors.—The bill would increase from $10,000 to $50,000 the minimum value of the agreement between a medicare provider and a subcontractor for purposes of requiring access to subcontractor records.

Medicare recovery against certain third parties.—The bill would establish the right of medicare to recover directly from certain third parties, such as workers compensation, auto and liability insurance.

Use of accrediting organizations for certain entities furnishing services.—The bill would authorize the Secretary to rely on certain accrediting organizations in determining whether rural health clinics, laboratories, clinics, rehabilitation agencies, including outpatient rehabilitation facilities, and public health agencies meet medicare requirements (and clarify the Secretary's authority with respect to ambulatory surgical centers).

Confidentiality of accreditation surveys.—The bill would extend to surveys by the American Osteopathic Association and other national accreditation organizations the same disclosure protections given JCAH surveys.

Thirty-day coverage for services furnished by a home health agency after agreement has been terminated.—The bill would change from the end of the calendar year to 30 days after termination of a home health agency agreement, the ending of coverage for services provided under a plan established prior to the termination date of the participation agreement.

Termination of agreements with entities where owners and certain individuals have been convicted of certain offenses.—The bill would authorize the Secretary to exclude from medicare participation any entity in which ownership or controlling interest is held by a person convicted of a program-related criminal offense, or in which an officer, director, agent or managing employee was convicted of such a criminal offense.

Elimination of the Health Insurance Benefits Advisory Council.—The bill repeals section 1867 of the Social Security Act, thus eliminating the Health Insurance Benefits Advisory Council.

Open enrollment for health maintenance organizations and competitive medical plans.—The Secretary would be directed to designate one 30-day period each year in which all of the medicare participating HMO's in a geographic area must have an open enrollment period.

Date for report on physician payments.—The bill would specify the date on which the Secretary of Health and Human Services is required by present law to report to Congress recommendations on the advisability and feasibility of making payments for physician's services furnished to hospital inpatients based on a diagnosis-related group (DRG) system and legislative recommendations thereon. The report would be due July 1, 1985.

Flexible sanctions for noncompliance with requirements for end-stage renal dialysis facilities.—The bill would allow the Secretary to apply intermediate sanctions to ESRD facilities when noncompliance does not justify decertification of such facilities.

Removing costs of nurse anesthetists from DRG-based payments.—For a temporary period, hospitals employing certified registered nurse anesthetists (CRNAs) would be reimbursed on a reasonable cost basis, as determined by the Secretary, for services of CRNAs. The Secretary would be required to report with recommendations on payments for CRNAs under the prospective payment system.

Determination of hospital area wage index.—The Secretary would be directed to establish criteria under which a hospital could demonstrate, for purposes of medicare prospective payment, that the area wage index inaccurately reflects the labor market conditions it actually faces; adjustments in payment could be made where the Secretary deems appropriate. The Secretary would also be directed to consult with the Department of Labor and BLS to develop an improved area wage index.

Definition of bona fide emergency services.—Existing law provides for reduced payment for physicians' services in hospital outpatient departments except for "bona fide emergency services." The bill would establish the following statutory definition of emergency services:

> Services provided in hospital emergency rooms after the onset of a medical condition manifesting itself by symptoms of sufficient severity that the absence of immediate medical attention could reasonably be expected by a pru-

dent layperson possessing an average knowledge of health and medicine to result in (a) placing the patient's health in jeopardy; (b) serious impairment to bodily functions; (c) serious dysfunction of any bodily organ or part; or (d) development or continuance of severe pain.

Delay of effective date for single-rate for skilled nursing facilities.—The single-rate for hospital-based and freestanding skilled nursing facilities would be delayed from October 1, 1983 until April 1, 1984.

Title XI—Trade Adjustment Assistance Programs

Title XI contains three amendments to the trade adjustment assistance (TAA) programs for workers and firms under the Trade Act of 1974, as amended under the Omnibus Budget Reconciliation Act of 1981. These programs were recently reauthorized for a two-year period until September 30, 1985, under Public Law 98-120. The amendments become effective on the date of enactment of the bill.

III. GENERAL REASONS FOR THE BILL

The Federal tax system, the social security system and medicare program, three areas within the committee's jurisdiction, directly affect more citizens than perhaps any other programs of the Federal Government. It is, therefore, vital that these items be reviewed periodically to determine whether they are working as Congress intended. Likewise, from time to time the committee should examine these provisions in light of changes in circumstances. It is also important that the committee react rapidly when abuses of the system come to its attention.

This year the committee, at both the full committee level and working through its various subcommittees, has reviewed numerous areas of the tax law, the social security disability program and the medicare program and has identified problems which must be addressed.

The tax system, in particular, is by any standard extremely complex and requires continuing review to determine whether it can be made simpler and fairer for the majority of citizens. Fairness requires that unintended benefits be removed.

The committee believes that several major modifications in the tax code are needed: to simplify the tax system, to prevent the benefits of tax incentives from resulting in unintended subsidies and distortions in economic behavior, to improve the fairness and efficiency of the system, to impose limits on tax incentives that have grown excessively in recent years, and to revise the structure of the taxation of the life insurance industry. This bill contributes to achieving each of these goals.

The committee has also engaged in substantial review of the social security disability program, which has been the focus of extensive public and Congressional scrutiny over the last several years. The committee bill will clarify several major areas of uncertainty with respect to the appropriate standards of review for disability beneficiaries, as well as improving the disability determination process in several other respects.

Further, the committee has reviewed certain health care cost provisions under the medicare program and has made various revisions.

Simplification of the tax law

The committee recognizes that many provisions of the present tax system that affect large numbers of individuals and businesses are unnecessarily complicated. Numerous provisions contain traps for the unwary, while at the same time afford opportunities for the well-advised to pay less than their fair share of taxes. Similar transactions are often taxed differently—not because Congress intended them to be taxed differently but because the system is so complex.

The committee is concerned about the extremely serious consequences that flow from the complexity of the tax system. First, a complex system is open to manipulation and abuse. Taxpayers can take advantage of the lack of clarity in the rules to reap unintended benefits. Transactions can be structured to circumvent intricate, unclear rules more easily than simple, precise rules.

Second, a complex system can confuse and mislead unsophisticated taxpayers. Inadvertent failure to comply with any one rule, hidden within a maze of other rules, can have harsh results. For a particular taxpayer, there may be no relief from the impact of these harsh results; for other taxpayers, the results may be mitigated only by litigation or legislation. Furthermore, even if the problem is corrected by legislation eventually, the delay between identifying the problem and its solution can itself cause hardship.

Third, the cost of structuring transactions to take advantage of intended benefits and to avoid unintended pitfalls can be substantial—often beyond the reach of the average taxpayer. Transactions that involve relatively small amounts may be just as complex as transactions that involve millions of dollars, but the cost of structuring a transaction is often proportional to the complexity, not the amount of money involved.

Fourth, a complex system discourages compliance with the tax laws. Statistics prepared by the Internal Revenue Service indicate that noncompliance is growing. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress enacted provisions designed to improve compliance; the focus then was on the withholding, information reporting, and penalty provisions. In this bill, the committee chooses to focus on simplification to improve compliance. By making the rules easier to understand, taxpayers are more likely to abide by them.

The committee believes that the process of simplification should be a continuing process. Problems should be remedied as they arise; simplification of portions of the present system should not be delayed until simplification of the whole system is attempted As part of this on-going process, this bill includes, therefore, a combination of simplification measures: clarification of some relatively narrow provisions, plus fundamental reform of other areas.

Excessive tax benefits

Over the past few years, Congress has enacted substantial incentives to stimulate capital formation. In particular, Congress believed that investment, in excess of the amounts needed to replace worn-out plant and equipment, should be encouraged in order to increase capacity and thereby promote economic growth. Incentives such as more generous depreciation deductions and the investment tax credit were intended to reduce the income tax that would otherwise be imposed on these investments.

However, Congress did not intend these incentives to affect the purchase of capital goods by Federal, State or local governments or by tax-exempt entities. Governmental investment decisions should be made in the appropriations process. Since there is no tax to discourage investment by a tax-exempt entity, a reduction in tax should be irrelevant to investment decisions.

Although tax-exempt entities cannot benefit directly from tax incentives to invest, they can gain considerable indirect benefits by leasing property at reduced rates from taxpayers. The difference between the cost of leasing at these reduced rates and the cost of purchasing property with tax-exempt financing is a benefit (over and above tax exemption itself) effectively paid by the Federal Government to the tax-exempt entity. Moreover the cost to the Federal Government is more than the benefit received by the tax-exempt entity—some of the benefits go to the owner of the property and to financial and other intermediaries. Furthermore, not every tax-exempt entity is assisted by these tax benefits; only those who choose to lease rather than purchase are assisted. Thus, the excess benefits are not only unintended, they are also inefficient and inequitable.

The committee believes that tax-reducing incentives should be provided to those who are subject to the income tax and denied to those who are not subject to the tax. The tax system exists to collect from taxable entities, not to make payments to tax-exempt entities. Any Federal aid to tax-exempt entities in excess of tax exemption itself should be direct, through appropriations, rather than indirect, through the transfer of tax benefits. Where an acquisition of property by the Federal government is involved, the proper forum for deciding whether Federal revenues should be spent is the appropriations process, not the tax system. Accordingly, the committee bill eliminates the excessive tax benefits for property used by tax-exempt entities.

A second area where the tax law provides excessive benefits is the use of tax-exempt bonds for private purposes. In recent years, the growth of such bonds has proceeded far beyond what was originally intended by Congress and has significantly raised interest rates on the general obligation bonds that State and local governments issue to finance their operations.

Taxation of the life insurance industry

The committee believes that the structure of the taxation of life insurance companies should be fundamentally revised.

The Life Insurance Company Tax Act of 1959 (on which present law is based) was designed to ensure that the life insurance industry as a whole paid a target amount of tax and that the distribution of this tax burden within the industry was balanced. To achieve the target level and the balance, present law provides special deductions and deferrals that benefit companies in different ways. The benefits depend, however, on the economic environment (particularly the level and volatility of interest rates) and industry practices. In the past few years, the pressure of high interest rates, inflation, and new life insurance products upset this balance; the complex three-phase structure of present law is not flexible enough to maintain an appropriate tax on the insurance industry in a time of dramatic changes in the economy and in industry practices. The committee believes that a simpler single-phase tax, more like that imposed on corporations in other industries, will ensure that companies benefit equally from all deductions.

The committee is concerned that these revisions not result in increasing by substantial amounts the tax liability of companies. The bill, therefore, provides rate reductions for small companies and an overall rate reduction to help alleviate any adverse impact of the new rules.

Tax equity

The committee is concerned that the tax system be as equitable as possible and, equally important, be perceived by taxpayers as fair. The tax system relies heavily on self-assessment and voluntary compliance. If taxpayers believe that the tax burden is distributed fairly, they are more likely to pay their share; if they believe that the system is unfair, they are less likely to pay. Even a relatively moderate increase in compliance would go a long way toward raising revenue without having to increase the taxes of those taxpayers who already pay their fair share.

The committee believes that efforts to correct inequities not only correct the immediate problem but, indirectly, improve compliance. Complete equity is often difficult to achieve, however. For example, corporate officers or other highly compensated employees are more likely to receive additional compensation in the form of fringe benefits than employees who earn less. Clearly, it is fair to tax compensation regardless of the form in which an economic benefit is received. But it is difficult to define and to some value fringe benefits; and the problem is complicated further by the long-standing administrative practice of not taxing many of these benefits. The committee believes that this bill, with its nondiscrimination requirements that generally apply to tax-free fringe benefits, substantially improves the equity and administration of the tax law in this area.

The committee also reviewed the rules governing the tax treatment of private foundations, which principally had been enacted in the Tax Reform Act of 1969. The committee reaffirmed the principal objective of the 1969 Act provisions, which is to ensure that the assets and income of private foundations will be devoted exclusively to charitable purposes. The committee believes that the modifications made by the bill concerning the deductibility of contributions to foundations, the rules applicable to expenditures, investments, and transactions of foundations, and the sanctions for violation of the foundation rules, are desirable to carry out the overall intent of the 1969 Act and to encourage further philanthropic works of private foundations.

The provisions of this bill remedy a wide variety of problems, many of which may not be significant individually. Nevertheless, the committee believes that taken as a whole the bill makes an important contribution to equity—both actual and perceived.

Social Security disability insurance

The committee's bill also amends Title II of the Social Security Act to provide for needed reforms in the administration of the disability determination process. Policies and procedures followed since March 1981 in reviews of individuals receiving disability benefits have in some cases resulted in an unwarranted termination of benefits. While the committee recognizes that it would be impossible to operate a program as large as the social security disability insurance programs without some anomalies, the committee believes the severity of the problems, actual and perceived, which have arisen in recent months both requires and is best alleviated through firm and expenditious Congressional direction.

The committee is aware of several areas where current policy or procedure is outdated or is inadequate to enable adjudicators to process disability reviews in a humane and logical manner, and this legislation provides appropriate guidelines and procedures for those areas. Specifically, the bill establishes a standard of medical improvement for evaluation of continuing eligibility, establishes standards regarding multiple impairments and requires establishment of new criteria in the mental impairment area. It provides for temporary delay of reviews of mental impairments, for new adjudicatory procedures centered on face-to-face interviews at the State agency level, and for continued benefit payments while cases are under appeal. The bill requires uniform public policy for all levels of adjudication, requires compliance with circuit court decisions, and makes certain other changes.

The committee stresses that the changes provided for by this bill do not constitute a change in the purpose and scope of the social security disability program, which is designed to provide benefits for those individuals who are so disabled they cannot work at all. The committee's primary concern is to preclude the recurrence of the kind of fluctuations in program experience that have occurred in recent years by addressing the urgent need to establish clear policy guidelines for the administration of the program. The bill does this without jeopardizing the financial stability of the disability program or incurring substantial long-term costs while at the same time assuring more effective and equitable administration of the disability determination process.

Medicare amendments

The Congressional Budget Office has estimated that the medicare trust fund will be depleted by the end of this decade. The committee recognizes the pressing need to look at means of reducing significantly the costs of the medicare program while protecting its integrity for present and future beneficiaries. Accordingly, the committee anticipates a full review of the options open to it during the coming session of Congress.

In the short term, the committee has made substantial spending reductions over the next three years. In addition, it has adopted several amendments to improve the adequacy of the program and to increase its administrative efficiency. In making these reductions in spending, the committee has made every effort to assure that there will be no harmful reductions in coverage to beneficiaries nor any increased costs to the elderly.

Trade adjustment assistance

The committee has reviewed the trade adjustment assistance programs and identified certain deficiencies which could be corrected without increasing the cost of the programs. The committee's bill accordingly, contains provisions that will improve the law by removing inequities in program coverage and benefits without adding to their budgetary cost.

IV. REVENUE AND OUTLAY EFFECTS OF THE BILL

Revenue effects

The revenue provisions of the committee bill involving statutory changes are estimated to increase net budget receipts by $2.31 billion in fiscal year 1984, $2.33 billion in fiscal year 1985, and $3.43 billion in fiscal year 1986. Thus, the total revenue raised during the first three fiscal years, 1984 through 1986, equals $8.07 billion.

Table 1 is a summary of the estimated revenue effects of the tax provisions of the committee bill for fiscal years 1984-1988 for the major categories of the bill (Titles I-VIII).

Table 2 shows the estimated revenue effects of each specific tax provision of the committee bill (Title I-VIII) for fiscal years 1984-1988.

Outlay effects

The outlay provisions of the committee bill are estimated to decrease outlays by $99 million, $298 million and $772 million for fiscal years 1984-1986, respectively. The impact of each provision is shown in greater detail in Part VI of this report.

Table IV-1

Summary of Estimated Revenue Effects of Tax Provisions of H.R. 4170, as reported by the Committee on Ways and Means, Fiscal Years 1984–88

[Millions of dollars]

Provision	1984	1985	1986	1987	1988
Title I. Tax-Exempt Entity Leasing Provisions	683	990	1,740	3,070	4,877
Title II. Life Insurance Tax Provisions [1]	748	819	788	788	791
Title III. Private Foundation Provisions	−13	−45	−46	−47	−50
Title IV. Simplification Provisions	935	541	620	706	613
Title V. Fringe Benefits Provisions	(2)	(2)	(2)	(2)	(2)
Title VI. Technical Corrections	(3)	(2)	(2)	(2)	(2)
Title VII. Private Purpose Bond Provisions	6	80	328	620	829
Title VIII. Miscellaneous Revenue Provisions	−52	−55	3	41	67
Total, Tax Provisions	2,307	2,330	3,433	5,178	7,127

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[1] The figures represent the estimated effects of the life insurance provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of insurance companies, are extended. If these provisions were allowed to expire at the end of 1983, the estimates would show decreases if fiscal year receipts of $252 million in 1984, $481 million in 1985, $553 million in 1986, $664 million in 1987, and $756 million in 1988.

[2] Negligible.

[3] Loss of less than $10 million.

Table IV-2

Estimated Revenue Effects of Tax Provisions of H.R. 4170, as Reported by the Committee on Ways and Means, Fiscal Years 1984–88

[Millions of dollars]

Provision	1984	1985	1986	1987	1988
Title I. Tax-Exempt Entity Leasing Provisions	683	990	1,740	3,070	4,877
Title II. Life Insurance Tax Provisions:					
Life insurance tax provisions[1]	763	884	923	997	1,076
Nondeductible IRAs ($1,750)	–15	–65	–135	–209	–285
Total, life insurance provisions	748	819	788	788	791
Title III. Private Foundation Provisions	–13	–45	–46	–47	–50
Title IV. Simplification Provisions:					
A. Estimated tax provisions:					
Measure penalties from "exception" amounts		–40	–40	–40	–40
Repeal "90 percent" and "this year's tax rates" exception from penalty	105		4	9	11
Allow penalty waiver	(2)	(2)	(2)	(2)	(2)
Estimated payments of the alternative minimum tax required	557	54	45	49	52
B. Domestic relations:					
Treatment of transfer of property between spouses or incident to divorce	(2)	(2)	(2)	(2)	(2)
Tax treatment of alimony and separate maintenance payments	–8	–46	–11	23	39

Dependency exemption in the case of child of divorced parents	[3]	[3]	[3]	[3]	[3]
Innocent spouse	[3]	[3]	[3]	[3]	[3]
Estate tax treatment of certain property settlements	[3]	[3]	[3]	[3]	[3]
Dependency exemption allowed for individuals in sheltered workshops	[3]	[3]	[3]	[3]	[3]
C. *At-risk rules*	[3]	[3]	[3]	[3]	[3]
D. *Estate tax provisions:*					
Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests	[2]	[2]	[2]	[2]	[2]
Alternate valuation election available only where it results in reduction of gross estate and estate tax		10	10	10	10
E. *Foreign provisions:*					
Definition of resident and nonresident aliens	[4]	[4]	[4]	[4]	[4]
Treatment of community income	[6]	[6]	[6]	[6]	[6]
Amendments related to foreign personal holding companies	[3]	[3]	[3]	[3]	[3]
Amendments related to section 1248	[3]	[3]	[3]	[3]	[3]
Coordination of subpart F with foreign personal holding company provisions	[6]	[6]	[6]	[6]	[6]
Stapled stock	[6]	[6]	[6]	[6]	[6]
F. *Miscellaneous Treasury administrative provisions:*					
Simplification of certain reporting requirements					
Removal of $1,000,000 limitation on working capital fund					

Table IV-2—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988
Increase in limitation on revolving fund for redemption of real property	(3)	(3)	(3)	(3)	(3)
Removal of $1,000,000 limitation on authority to dispose of obligations	(3)	(3)	(3)	(3)	(3)
Secretary of the Treasury authorized to accept gifts and bequests	(3)	(3)	(3)	(3)	(3)
Extension of time for court review of jeopardy assessment where prompt service not made on United States	(3)	(3)	(3)	(3)	(3)
Extension of period to assess unpaid taxes	(6)	(6)	(6)	(6)	(6)
Lien on assets of financial institutions for unpaid drafts	(3)	(3)	(3)	(3)	(3)
Disclosure of windfall profit tax to State tax agencies					
Provisions relating to distilled spirits:					
Repeal of occupational tax on manufacturers of stills and containers	(5)	(5)	(5)	(5)	(5)
Allowance of drawback claims even where certain requirements not met	(5)	(5)	(5)	(5)	(5)
Disclosure of alcohol fuel producers to administrators of State alcohol laws					
Repeal of stamp requirement for distilled spirits	(7)	(7)	(7)	(7)	(7)
G. Tax Court provisions:					
Small tax cases					
Annuities to survivors of Tax Court judges	(8)	(8)	(8)	(8)	(8)

Proceedings which may be assigned to commissioners					
Special trial judges					
Publicity of Tax Court proceedings					
Retirement age for Tax Court judges					
H. Simplification of income tax credits	223	456	437	401	202
I. Miscellaneous tax provisions:					
Rollover of certain partial distributions from qualified plans	(3)	(3)	(3)	(3)	(3)
Treatment of certain related party transactions	59	114	185	264	350
Preferred stock eligible for small business corporation treatment	(2)	(2)	(2)	(2)	(2)
Medical expense deduction for certain lodging	−1	−7	−10	−10	−11
Study of simplified gross income tax					
J. Repeal of certain obsolete provisions:					
Termination of rules relating to qualified bond purchase plans and retirement bonds					
Repeal of section 1251 (relating to gains from disposition of certain property used in farming)					
Total, simplification provisions	935	541	620	706	613
Title V. Fringe Benefits Provisions	(3)	(3)	(3)	(3)	(3)
Title VI. Technical Corrections	(9)	(3)	(3)	(3)	(3)
Title VII. Tax-Exempt Bond Provisions:					
A. Mortgage bonds extension and certificates	−48	−201	−418	−641	−859
B. IDBs	54	281	746	1,261	1,688
C. Certain educational tax-exempt bonds organizations	(9)	(9)	(9)	(9)	(9)

Table IV-2.—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988
Total, bond provisions	6	80	328	620	829
Title VIII. Miscellaneous Revenue Provisions:					
A. Tax treatment of certain conversions of residential rental property into condominium units	−37	−43	15	54	80
B. Nonrecognitions of gain from any net gift made before March 4, 1981	[2]	[3]	[2]	[2]	[2]
C. Disaster loss deduction—mudslides, etc	−15	−12	−12	−13	−13
D. Tax straddles—avoidance of accumulated earnings tax through use of foreign corporations	[4]	[4]	[4]	[4]	[4]
E. Money purchase pension plans	[3]	[3]	[3]	[3]	[3]
Total, miscellaneous provisions	−52	−55	3	41	67
Grand Total, Tax Provisions	2,307	2,330	3,433	5,178	7,127

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[1] The figures represent the estimated effects of the life insurance provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of insurance companies, are extended. If these provisions were allowed to expire at the end of 1983, the estimates would show decreases if fiscal year receipts of $252 million in 1984, $481 million in 1985, $553 million in 1986, $664 million in 1987, and $756 million in 1988.

[2] Loss of less than $5 million.

[3] Negligible.

[4] Gain of less than $10 million.

[5] Loss of less than $1 million.

[6] Gain of less than $5 million.

[7] Reduces outlays by $2 million.

[8] Increases outlays by a negligible amount.

[9] Loss of less than $10 million.

V. EXPLANATION OF THE BILL

TITLE I—TAX-EXEMPT ENTITY LEASING ACT OF 1983

A. Present Law

Summary

Under present law, the rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code. Rather, they are embodied in a series of court cases and revenue rulings and revenue procedures issued by the IRS. Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits of the ownership of property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

In general, the tax benefits of ownership of property include depreciation or accelerated cost recovery deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over relatively short periods. For most property, the ACRS recovery period is shorter than the actual useful life of the property. Investment credits permit taxpayers to reduce their tax liability by a percentage of their investment in eligible property. Eligible property includes certain depreciable personal property. Additional investment credits are available for certain energy property and to certain improvements to buildings at least 30 years old.

As a general rule, governmental units and tax-exempt organizations are not entitled to depreciation deductions or investment credits for property owned by them. Moreover, no investment credit is allowed for property used (though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). The nontaxable use restriction does not affect the allowance of ACRS deductions and certain other tax benefits.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States (foreign-use property), then, in general, ACRS deductions are reduced and no investment credit is allowed.

The traditional reasons for leasing stem from tax, accounting, and a variety of business considerations. Tax-exempt organizations and governmental units have leased equipment for many of the same reasons as taxable entities. The recent increase in leasing and similar arrangements is due, in part, to budgetary limitations on the purchase of property and, in the case of some State and local governments, limitations on their ability to issue tax-exempt bonds. From a tax perspective, leasing allows certain tax benefits (such as ACRS deductions) to flow through (in the form of reduced rents) to nontaxable entities that are not eligible for such benefits on their own account. In some cases, the reasons for arranging a transaction with a nontaxable entity as a service contract or in some other form stem from a desire to avoid the nontaxable use restriction on the investment credit.

What follows is a description of the present-law rules governing the determination of ownership of property for Federal income tax purposes, in the context of leases or similar arrangements, and a description of the nontaxable use restriction on the investment credit. The rules governing ACRS and the investment credit for foreign-use property are also discussed.

The ownership issue

Overview

The determination of the Federal income tax ownership of property requires a case-by-case analysis of all facts and circumstances. Although the determination of ownership is inherently factual, a number of general principles have been developed in court cases, revenue rulings, and revenue procedures.

In general, both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive, so long as the transaction also has a bona fide business purpose and the person claiming tax ownership has sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must possess meaningful burdens and benefits of ownership. The lessor must be the person who suffers, or benefits, from fluctuations in the value of the property. Thus, lease treatment is denied, and the lessee is treated as the owner, if the lessee has the option to obtain title to the property at the end of the lease for a price that is nominal in relation to the value of the property at the time the option is exercisable (as determined at the time the parties entered into the agreement) or which is relatively small when compared with the total lease payments to be made.

Where the lessor's residual value in the property is nominal, the lessor is viewed as having transferred full ownership of the property for the rental payments. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor is viewed as having transferred full ownership because of the likelihood that the lessee will exercise the option. Furthermore, if the lessor has a contractual right to require the lessee to purchase the property at the end of the lease (a put), the transaction could be denied lease treatment because the put eliminates the lessor's risk of loss in value of the residual interest and the risk that there will be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

To give taxpayers guidance in structuring leveraged leases (i.e., leases in which the property is financed by a nonrecourse loan from a third party) of equipment, the IRS issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the IRS generally will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. Thus, if all the requirements of the guidelines are not met, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction is a lease under the general principles described above.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property.
2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). That rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the exercise date.
3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property.
4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any loan to the lessor.
5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit and have a positive cash flow from the transaction independent of tax benefits.
6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for leveraged lease treatment.

Nontaxable use restriction on the investment credit

General rule

Property that is "used by" a tax-exempt organization in an exempt function or by a governmental unit generally is ineligible for the investment credit (secs. 48(a)(4) and 48(a)(5)), including the investment credit for energy property. For this purpose, a governmental unit includes the United States government, any State or local government, most international organizations, and any instrumentality of the foregoing. A tax-exempt organization is almost any organization exempt from Federal income tax, such as a charitable or educational organization.

To determine whether property is subject to the nontaxable use restriction, it is first necessary to evaluate the economic substance of the transaction under the general principles for determining who is the tax owner of property.[1]

Under the nontaxable use restriction, the investment credit is unavailable with respect to property that is treated for Federal income tax purposes as being owned by a governmental unit or a tax-exempt organization for use in its exempt function. In addition, property leased to a governmental unit or a tax-exempt organization for use in its exempt function is generally subject to the nontaxable use restriction. However, in addition to several statutory exceptions to the nontaxable use restriction, one court has held (and the IRS has ruled) that the investment credit can be claimed where the governmental unit essentially has contracted for a service, to be provided by the owner of property, rather than for the use of the property itself.

Statutory exceptions to the nontaxable use restriction

Tax-exempt organizations.—Under present law, certain farmers' cooperatives (which are considered exempt from tax even though they are subject to the rules of subchapter T, relating to cooperatives and their patrons) are excluded from the restriction on use by a tax-exempt organization. Also, the credit is allowed for property used by a tax-exempt organization in a taxable unrelated trade or business.

Foreign governmental units.—Although international organizations generally are subject to the restriction, property used by the International Satellite Consortium, the International Maritime Satellite Organization, and any successor organizations is excluded from the restriction on governmental use. Foreign governments and possessions of the United States are not subject to the restriction. Thus, a computer leased to the United States Government is denied the credit, but a computer leased to a foreign embassy located in the United States is allowed the credit.

Rehabilitated buildings.—Under present law, rehabilitation tax credits are available for qualified rehabilitation expenditures incurred for older buildings leased to tax-exempt organizations or to governmental units.

Foreign persons.—Property used by foreign persons is not subject to the nontaxable use restriction. However, special rules (discussed below) apply if the property is used predominantly outside the United States.

"Casual or short-term lease" exception

Under Treasury regulations, there is an exception to the nontaxable use restriction for property that is leased on a "casual or short-term basis" (Treas. Reg. sec. 1.48-1(j) and (k)).

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[1] Rev. Rul. 68-590, 1968-2 C.B. 66. Revenue Ruling 68-590 involved arrangements between a taxable corporation and a political subdivision of a State providing for the tax-exempt financing, construction, and operation of an industrial project. The IRS did not apply the nontaxable use restriction even though the governmental unit held legal title under a sale-and-leaseback. Rather, the IRS held that the corporation was the tax owner of the property. The IRS reasoned that, in view of the economic substance of the arrangement, the sale-leaseback arrangement was nothing more than a security device for the protection of the holders of the tax-exempt bonds.

Casual leases.—The term "casual lease" has been interpreted to mean a lease that lacks the formalities inherent in a written lease.[2] Another example of a casual lease might be the lease of an automobile from a car rental company by a governmental employee traveling on governmental business.[3]

Short-term leases.—The exception for short-term leases has been recognized as a means of allowing the government to fulfill an unforeseen or extraordinary need for obtaining the short-term use of property from the private sector, without causing the taxpayer to lose the credit.[4] Thus, property not ordinarily intended for lease to a tax-exempt organization or governmental entity may be leased under the exception for a short period in unforeseen or extraordinary circumstances.

In determining whether the exception for short-term leases applies, the courts have rejected the contention that the relevant consideration is whether the nonqualifying use constitutes a substantial portion of the useful life of the property.[5] The courts have also rejected the position that short-term use should be determined on the basis of the minimum legally enforceable period of a lease.[6]

"Service contract" exception

Internal Revenue Service rulings.—Under Treasury regulations (sec. 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization means property owned by or leased to one of those nontaxable entities. In Revenue Ruling 68-109, 1968-1 C.B. 10, the IRS ruled that property provided to a governmental unit as an integral part of a service is not "used by" the government within the meaning of section 48(a)(5).

Revenue Ruling 68-109 involved communications equipment installed by a public utility on the premises of governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the IRS relied on the fact that the taxpayer retained all ownership in and possession and control over the equipment. The IRS also focused on the fact that the communications equipment was part of an integrated network used to render services to the customer, not property placed with a user to allow it to provide services to itself.

The IRS has issued a number of other rulings, including private rulings,[7] interpreting the service contract exception. For example, the investment credit has been denied in situations involving trucks operated under a service contract by government employees (Rev. Rul. 72-407, 1972-2 C.B. 10) and school buses operated by a private party under contract with a local school district (LTR 8104001 (February 27, 1980)). However, in LTR 8217040 (January 27, 1982), the IRS allowed the investment credit in a situation involving a time charter of a vessel to the Federal government. The

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[2] See, *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981).

[3] *Id.*

[4] *World Airways, Inc. v. Commissioner*, 564 F.2d 886 (9th Cir. 1977), *aff'g*. 62 T.C. 786 (1974).

[5] *World Airways Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

[6] Thus, the mere fact that a lease contains a cancellation clause will not result in application of this exception. *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981); *Stewart v. U.S.*, 77-2 U.S.T.C. 9648 (D. Neb. 1977).

[7] A private ruling is not binding as precedent on the IRS with respect to taxpayers other than the taxpayer who received the ruling, or the courts.

IRS ruled that the taxpayer could claim an investment credit for the vessel based on the taxpayer's representations that the taxpayer bore the risk of loss with respect to the vessel, the taxpayer had to retain possession and control over the vessel, the taxpayer was required to provide maintenance and secure insurance for the vessel, the taxpayer had to furnish and control the crew of the vessel, and the time charter transferred no legal interest in the property to the Federal government.

The case law.—The only judicial decision dealing with the service contract exception to the nontaxable use restriction is *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981). In *Xerox*, a manufacturer provided duplicating machines to the Federal government. The IRS had issued a revenue ruling involving the same basic facts as in *Xerox* that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the IRS's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397). The court rejected the government's contention that the service contract exception cannot ever apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (i.e., Rev. Rul. 68-109). The court emphasized that *Xerox* was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would have been different if the Treasury regulations had formulated the precise confines of the service contract exception.

Although the published and private rulings do not articulate any single test for use in determining whether an agreement is a service arrangement or a lease, the court felt that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained by the taxpayer and (2) the degree to which the property supplied is a component of an integrated operation in which the taxpayer has other responsibilities.

In holding that the interest conveyed to the customer was not sufficient to constitute a leasehold interest, the *Xerox* court focused on the following factors drawn from the IRS rulings in which a service contract was held to exist: (1) the taxpayer retained ownership of the machines, (2) the taxpayer decided whether to repair, replace, or alter the machines, and the customer was prohibited from altering or moving the machines, (3) the taxpayer bore the cost of adjustments, repairs, and replacements, (4) the taxpayer was responsible for loss or damage, except in the case of the customer's negligence, and (5) the customer could cancel upon 15 days notice.

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers, not just the government, and that governmental use represented only 5 or 6 percent of the taxpayer's machines.

Foreign-use limitations

Overview

Property "used predominantly outside the United States" is subject to reduced ACRS deductions and is not allowed the investment credit (secs. 168(f)(2) and 48(a)(2)).

In general, property "used predominantly outside the United States" means property used outside the United States for more than half of the taxable year. However, there are a number of exceptions to this general rule. For example, communications satellites are excepted from the rules for foreign-use property. U.S.-flag vessels operated in the foreign or domestic commerce of the United States are excepted, as are aircraft registered by the Federal Aviation Agency and operated to and from the United States [8] or operated under contract with the United States, even if operated by a foreign airline. Special rules are also provided for certain rolling stock, drilling rigs, motor vehicles, containers, submarine cables, and other property.

ACRS deductions

The recovery period for computing ACRS deductions for recovery property used predominantly outside the United States is equal to the present class life (mid-point life) for the property, as of January 1, 1981, under the prior law ADR system. For personal property for which there is no ADR mid-point life as of January 1, 1981, a 12-year recovery period must be used. The determination of useful lives based on facts and circumstances is not permitted. The owner of foreign-use personal property generally is allowed to use the 200-percent declining balance method of depreciation for the early years of the recovery period and the straight-line method for later years.

For foreign real property (including all components of a building), the recovery period is 35 years. The owner of foreign real property is generally allowed to use the 150-percent declining balance method for the early years of the recovery period, switching to the straight-line method in later years.

In the case of foreign-use personal property or foreign real property, the straight-line method of depreciation can be used in lieu of the prescribed accelerated methods. In addition, for foreign-use personal property, the taxpayer may elect the straight-line method over one of the longer recovery periods allowed for domestic property (but the period elected may not be shorter than the ADR mid-point life, or, for property without an ADR mid-point life as of January 1, 1981, 12 years). For foreign real property, the taxpayer may elect to use the straight-line method over a recovery period of 45 years (instead of 35 years).

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[8] The IRS has ruled that a plane returning to the United States only once every two weeks qualifies as being operated to and from the United States. Rev. Rul. 73-367, 1973-2 C.B. 8. Furthermore, an airplane can be leased for temporary use outside the United States without any investment credit recapture. Under section 47(a)(7)(A), 3 1/2 years qualifies as temporary use for this purpose.

B. Reasons For Change

Overview

The committee believes that reform of the tax law is essential, insofar as it relates to property used by tax-exempt entities under a lease, a lease formulated as a service contract, or other similar arrangements. When tax-exempt entities use property under these arrangements, they pay reduced rents that reflect a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefit from investment incentives for which they do not qualify directly, and effectively gain the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities have been turned into unintended benefits for tax-exempt entities, including foreign entities. The benefits are equivalent to an open-ended spending program, operated within the tax system, that increases the Federal deficit, encourages tax-exempt entities to dispose of the assets they own and forego control over the assets they use, disorders public budgeting processes, and feeds a popular perception that the tax system is open to manipulation.

The committee is greatly concerned about these problems, the scale of which has been magnified by the recent surge in leasing to tax-exempt entities and other arrangements devised to transfer tax benefits to them. In response, the committee bill restricts tax benefits for property used by tax-exempt entities so that the Federal tax outflow will be eliminated and tax-exempt entities will be able to lease property on the same tax-free basis as they can purchase it.

Background

In 1962, Congress first enacted the investment tax credit for certain property used in a trade or business or for the production of income. The purpose of the credit is to reduce the income tax liability of taxpayers and thereby encourage their purchase and use of capital goods. When enacting the investment credit, Congress expressly disallowed it for property used by governmental units and tax-exempt organizations, which of course have no income tax liability to reduce. However, the provision was necessary to prevent these tax-exempt entities from indirectly gaining—through leasing, for example—the benefits of both tax-exemption and the income tax credit. This policy has been continued to the present. It is grounded in the fundamental principle that the tax system exists to collect from taxable entities, not to make payments to tax-exempt entities.

The committee believes that the policy of providing tax-reducing incentives to those who are subject to the income tax and denying them to those who are not subject to the income tax should be maintained, and that three major amendments are needed to improve its application. The amendments relate to (a) accelerated depreciation deductions, (b) transactions structured to avoid the present denial of the investment credit, and (c) the treatment of foreign tax-exempt entities.

Accelerated depreciation deductions

Over the last two decades, Congress has acted to accelerate cost recovery (depreciation) deductions for property used in a trade or business or for the production of income. The introduction of the Asset Depreciation Range system in 1971 and the enactment of the Accelerated Cost Recovery System in 1981 were two significant steps in this direction. The purpose of accelerating cost recovery deductions is to reduce the income tax liability of taxpayers in order to encourage their purchase and use of capital goods. Taking into account the time value of money, accelerated deductions reduce the present value of tax to be paid by deferring payment to later years.

The cumulative effect of legislation relating to cost recovery allowances is that these deductions currently operate, like the investment credit, as a significant investment incentive, by reducing the value of the tax that would otherwise be imposed on the investment. However, present law does not generally deny the benefits of accelerated cost recovery for property leased to tax-exempt entities. As a result, the transfer of benefits to these entities through the tax system that Congress acted to prevent with respect to the investment credit is now occurring due to accelerated depreciation deductions. Therefore, the committee bill provides for less rapid write-offs of property used by tax-exempt entities, such that the Federal tax outflow will be eliminated and tax-exempt entities will be able to lease property on the same tax-free basis as they can purchase it.

Transactions structured to avoid investment credit restrictions

The committee understands that the value of the investment credit is sufficiently great to have prompted more attempts to structure transactions in a form other than a lease, such that property used by a tax-exempt entity or dedicated primarily to its use will nevertheless qualify for the credit. The committee is concerned that Congress has not provided statutory guidance for determining when property is in substance used by a tax-exempt entity. Therefore, the committee bill provides criteria for this purpose, so that the economically insubstantial restructuring of a lease as a service contract or similar arrangement will not result in unintended, preferential tax treatment.

Foreign tax-exempt entities

The present law denial of investment credit for property used by tax-exempt entities is incomplete because it does not apply to substantial amounts of certain types of property which are leased by foreign governments and other foreign persons who are not subject to Federal income tax. As a result, this property qualifies for greater tax benefits than property leased to the Federal government, State or local governments, or domestic organizations which also are not subject to Federal income tax.

The committee believes that tax benefits for property used by foreign tax-exempt entities should not exceed tax benefits for property used by domestic tax-exempt entities. The committee is unconvinced that the current preferential treatment for foreign lessees of certain equipment should be maintained as an export subsidy. First, the current benefits are available without regard to whether the equipment was produced in the United States. Thus, the Federal government contributes to the foreign manufacture and use of equipment which is owned by a U.S. lessor. Second, the impact of the current tax benefits in stimulating exports is diluted to the extent that they are retained by the lessor, rather than being flowed through to the foreign lessee as reduced financing costs. Third, to the extent that financing costs are reduced for the foreign lessee (which could be tax-exempt in its home country), they provide lower prices to foreign businesses for goods or services which may be in direct competition with U.S. businesses. Fourth, preferential tax benefits for foreign governments to lease equipment would place them in a more favorable position than to State and local governments. Fifth, the committee is aware that direct credit assistance is available for exporters of U.S.-produced goods through the Export-Import Bank. Therefore, the committee bill does not except foreign lessees from the general policy of subsidy-free tax treatment for property used by tax-exempt entities.

The committee is aware that the United States has entered into treaties that, on a reciprocal basis, exempt residents of the treaty partner from U.S. tax on certain shipping and aircraft income. However, those provisions do not in any way guarantee to residents of those countries the benefits of the investment tax credit or any accelerated depreciation regime.

Additional reasons

The committee has additional reasons for believing that the tax benefits (in excess of tax exemption itself) currently available to tax-exempt entities through leasing should be eliminated.

First, the Federal budget is in no condition to sustain the substantial revenue loss resulting from leasing to tax-exempt entities, which will certainly increase as more tax-exempt entities, financial entities, and tax-oriented investors learn how to take advantage of the tax system in that way. Nothing is accomplished to reduce budget deficits when spending cuts are matched or exceeded by revenue losses. These losses are especially large in transactions involving debt-financed property.[9]

Second, the committee is concerned about possible problems of accountability of governments to their citizens, and of tax-exempt organizations to their clienteles, if substantial amounts of their property should come under the control of outside parties solely because the Federal tax system makes leasing more favorable than owning. The committee is convinced that the tax system should not encourage tax-exempt entities to dispose of the assets they own or to forego control over the assets they use.

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[9] With respect to tax benefits for debt-financed property, see Joint Committee on Taxation staff pamphlet, "Description of S. 1564 Relating to Tax Treatment of Property Leased to Tax-Exempt Entities" (FCS-34-83).

Third, the committee believes that Federal aid to tax-exempt entities (above and beyond their tax exemption) should be made by appropriations rather than by tax benefits transfered through the tax system. The tax benefits in leasing are open-ended and hence uncontrollable in amount and composition, whereas appropriations are limited and adjustable to current priorities from year to year. Moreover, tax benefits appear in the Federal budget only as reduced tax collections, unassociated with any particular public purpose. Thus, with Federal aid conveyed through the tax system, it is very difficult to discover what tax-exempt purposes have been federally assisted, by how much they have been assisted, and whether the assistance has been rendered in ways consistent with other objectives of public policy. These matters can be known, debated, and decided in the appropriations process.

Fourth, the committee is concerned about waste of Federal revenues. Although under present law tax benefits exist to be shared by the tax-exempt user of property and the taxable owner, there is no assurance that the tax-exempt entity will be the prime beneficiary. For example, when a substantial portion of the benefit is retained by lawyers, investment bankers, lessors and investors, the Federal revenue loss becomes more of a gain to financial entities than to tax-exempt entities. In proportion to that inefficiency, the Treasury loses more than $1 to provide $1 of aid to tax-exempt entities through leasing, whereas the aid could be provided on a dollar-for-dollar basis through appropriations. This problem exists within the Federal government also. To the extent that a Federal agency as lessee pays rents that do not reflect a full pass-through of the lessor's income tax benefits, the Federal government pays more to lease an asset than it would to buy it. The committee received considerable testimony to the effect that Federal leasing procedures are inadequate to prevent this waste.

Fifth, the committee stresses the need to sustain popular confidence that the tax system is generally working correctly. A system which entices Federal agencies not to own their essential equipment, nor colleges their campuses, nor cities their city halls, and which also rewards taxpayers who participate in such transactions with a lighter tax, risks eroding that confidence.

C. Explanation of Provisions

(Secs. 101–103 of the Bill and Secs. 48 and 168 of the Code)

1. Overview

In general, the committee bill reduces the tax benefits that would otherwise be available for property used by tax-exempt entities. The bill defines the term "tax-exempt entity" to include Federal, State, local, and foreign governments, possessions of the United States, international organizations, certain instrumentalities of the foregoing, and certain foreign persons, as well as most organizations that are exempt from Federal income tax or were exempt at any time within a prescribed 5-year period.

The bill also provides criteria for use in determining whether an arrangement characterized by the parties as a "service contract" or carrying some other label should, for purposes of determining whether property is tax-exempt use property (defined below), be treated as a lease to the tax-exempt entity. However, the bill creates no inferences regarding the present-law treatment of purported service contracts under the nontaxable use restriction on the investment credit.

To the extent a rehabilitated building is tax-exempt use property, rehabilitation credits are denied under the bill if the rehabilitation expenditures are, or acquisition of the building to be rehabilitated is, financed in whole or in part with tax-exempt obligations.

Special rules are provided for qualified technological property, property subject to short-term leases, and certain other property.

Present-law rules for determining the owner of property for income tax purposes are unchanged. Thus, the bill leaves open the possibility that a tax-exempt entity could be treated as the owner of property under a purported lease, service contract, or other arrangement. The bill creates no inferences regarding who under present law should be treated as the tax owner of property involved in such a transaction.

2. Definition of Tax-Exempt Entity

Under the bill, the term "tax-exempt entity," for purposes of both the depreciation and investment credit provisions, includes the United States, any State (including the District of Columbia) or local governmental unit, any possession of the United States (including Puerto Rico), and any agency or instrumentality of any of the foregoing (other than any agency or instrumentality of the United States or any State or local governmental unit all the income of which, if any, is fully subject to United States income tax and which does not operate as an instrumentality of the governmental unit).

The term also includes any organization, other than a farmers' cooperative described in section 521, that is exempt from United States income tax and any organization (and any predecessor organization engaged in substantially similar activities) that was exempt from United States income tax (other than by virtue of section 521) at any time during the 5-year period ending on the date the property involved is first used by such organization. However, it is not intended that the bill treat property owned by any such former tax-exempt organization as tax-exempt use property.

For example, assume that a tax-exempt hospital has historically leased or owned automobiles for use in carrying out its tax-exempt function. On January 15, 1984, the hospital creates a wholly-owned taxable subsidiary to lease new automobiles and provide transportation services to the hospital. Automobiles leased by the subsidiary any time prior to January 15, 1989, will be tax-exempt use property.

In addition, the term includes any foreign government, any international organization, any agency or instrumentality of either of the foregoing, and any other person who is not a United States person, but only with respect to property 50 percent or less of the gross income, if any, derived by the foreign lessee from the use of which is subject to United States income tax for the taxable year of the foreign lessee. In determining whether the 50-percent threshold is satisfied, the portion of the gross income derived by the foreign lessee from the use of the property that is subject to U.S. income tax is to be determined after taking into account all exclusions and exemptions, whether derived from a statute, a treaty, or otherwise, but total gross income from the use of the property is to be determined without regard to any such exclusions or exemptions.

3. Tax-Exempt Use Property

Personal property

For purposes of the depreciation and investment credit provisions of the bill, property which is not 15-year real property will be tax-exempt use property if it is owned by, leased to, or otherwise used by a tax-exempt entity. Except to the extent modified by the provisions of the bill dealing with service contracts or similar arrangements, the determination of whether personal property is tax-exempt use property is made under present law rules. Thus, for example, if a taxable entity manufacturers personal property for purchase by a tax-exempt entity in a normal commercial transaction, which is not an arrangement treated as a lease under the bill, the property used by the manufacturing entity to produce the property sold to the tax-exempt entity is not tax-exempt use property.

Real property

In general

For purposes of the depreciation and investment credit provisions of the bill, 15-year real property will be treated as tax-exempt use property if it is owned by a tax-exempt entity, or to the extent it is used by a tax-exempt entity or entities if at least one of the following circumstances exists:

(1) All or a part of the property was financed with the proceeds of tax-exempt obligations and the tax-exempt entity (or a related party) participated in such financing;

(2) The use is pursuant to a lease containing or accompanying (i) a fixed or determinable price purchase option exercisable by the tax-exempt entity (or a related party), (ii) a fixed or determinable price sale option pursuant to which the lessor can require the tax-exempt entity (or a related party) to purchase the property, or (iii) the equivalent of either such option;

(3) The use occurs after a sale, lease, or other disposition or transfer of the property by the tax-exempt entity (or a related party); or

(4) The use is pursuant to a lease with a term exceeding 80 percent of the remaining economic useful life of the property, determined at the time the lease is entered into.

However, in no event will any portion of any 15-year real property be treated as tax-exempt use property unless more than 20 percent of the property is used by a tax-exempt entity or tax-exempt entities in a use or uses of a type or types described above. For purposes of this rule, each building will be treated as a separate property unless two or more buildings are part of one project. In the latter case, the entire project will be treated as one property. Furthermore, uses of the types described above by unrelated tax-exempt entities will be aggregated in determining whether property is tax-exempt use property and the extent thereof, and use by one tax-exempt entity related to another tax-exempt entity will be treated as use by the latter as well as the former. Finally, the extent to which property is tax-exempt use property will be measured by those factors producing the greatest amount of tax-exempt use. For example, assume that a tax-exempt entity sells a building, leasing 50 percent of it back for more than 80 percent of remaining useful life and leasing the other 50 percent back for 10 years. Because the entire building was sold and leased back, the entire building is tax-exempt use property even though only one-half of it was leased to the tax-exempt entity for a term exceeding 80 percent of its remaining useful life.

The committee intends that a tax-exempt entity or entities will be treated as using more than 20 percent of a building only if it or they use or are entitled to use more than 20 percent of the net rentable floor space in the building. Net rentable floor space is not to include common areas.

To illustrate the application of the rules for determining whether and to what extent 15-year real property is tax-exempt use property, assume in the examples that follow that a tax-exempt entity participates in industrial development bond financing for the acquisition of a new building by a taxpayer. The tax-exempt entity leases 80 percent of the building for 5 years. Eighty percent of the building is tax-exempt use property under the bill. If the tax-exempt entity leased only 19 percent of the building for 5 years, no portion of the building would be tax-exempt use property. If the tax-exempt entity leased only 19 percent of the building for 5 years and another tax-exempt entity leased 10 percent of the building for a term in excess of 80 percent of the building's remaining useful life (or a related entity leased 10 percent of the building for 5 years), 29 percent of the building would be tax-exempt use property. If the tax-exempt entity leased only 19 percent of the building for 5 years and an unrelated tax-exempt entity leased 10 percent of the building for 5 years, none of the building would be tax-exempt use property. If the tax-exempt entity leased 75 percent of the building for a term exceeding 80 percent of the building's economic life, 75 percent of the building would be tax-exempt use property. This last conclusion would not change even if industrial development bonds had not been used.

Participation in tax-exempt financing

Whether a tax-exempt entity (or a related party) will be treated as having participated in financing the acquisition of all or a part of the property through tax-exempt obligations depends on all the circumstances. However, a tax-exempt entity will be treated as having participated if it (or a related tax-exempt entity) issues the obligations and it is reasonable to expect at the time of issuance that the tax-exempt entity will be a user of all or a portion of the property. A tax-exempt entity will also be treated as having participated in the financing if it has committed to lease space in the building subject to the successful completion of the financing and acquisition. For example, an organization described in section 501(c)(3) will be treated as having participated in a bond financing if, prior to the issuance of the bonds, it commits to enter into a lease of all or part of the property after it has been acquired by the taxpayer. If a tax-exempt entity finances the acquisition or construction of a building with tax-exempt obligations, sells the new building to the taxpayer before using it, and then leases all or a part of it, the tax-exempt entity will be treated as having participated in the financing.

Purchase or sale options

A fixed or determinable price purchase or sale option exists if the tax-exempt entity (or a related party), directly or indirectly, has a legally enforceable option to buy the property involved from the lessor, or the lessor has a legally enforceable right to "put" the property to the tax-exempt entity (or a related party), at either a pre-established price or at a price that is determinable pursuant to a formula. An option or put at fair market value at the time of exercise will not be treated as a fixed or determinable price option or put. Nor will an option or put be so treated if the selling price is determinable pursuant to a formula which the parties, when agreeing to it, reasonably expected would produce a number approximately equal to fair market value at the time of exercise. An option to purchase in 15 years for an amount equal to 50 percent of original cost will be an option at a fixed or determinable price. However, an option to purchase at a price derived by a formula which incorporates rents then paid by taxable entities for the use of the same or similar property and then-prevailing interest rates will not be an option at a fixed or determinable price, so long as the parties, when they agreed to the formula, reasonably expected it to produce a number approximately equal to fair market value at the time of exercise.

Furthermore, any provision which has the effect of passing on to the lessee or a related party the risk that the property's residual value will decrease will be treated as the equivalent of a fixed or determinable price put. For example, assume that a tax-exempt entity leases land to a taxable entity for 20 years. The taxable entity constructs a building, which has an economic useful life of 50 years, on the land and leases it to the tax-exempt entity for the balance of the term of the ground lease. Because the tax-exempt entity has dominion over the building for its entire economic useful life, the tax-exempt entity may be treated as its tax owner under present law. However, if the tax-exempt entity is not treated as the owner, the property would be tax-exempt use property in any event because the tax-exempt entity has the equivalent of a fixed price purchase or sale option. Similarly, assume that a lease provides that if the lessee cancels or fails to renew the lease or if the property involved is destroyed, the lessee will pay or cause to be paid to the lessor the difference between the amount necessary to preserve the lessor's net economic return and the fair market value of the property. The lease is treated as containing the equivalent of a determinable price sale option.

An option need not be contained in the lease. It may be a separate agreement. An option to buy or put stock in a corporation (or equity interests in any other entity) which owns the property may be treated as an option to buy or put the property.

Uses after transfers

The use by a tax-exempt entity after a disposition or other transfer of the property by the entity (or a related party) includes all forms of transactions in which a tax-exempt entity (or a related party), directly or indirectly, sells, leases, disposes of, or otherwise transfers property theretofore owned by it and subsequently uses it. For example, if a tax-exempt entity contributes a building to a partnership and leases back a portion of the building, the transaction will be treated as a sale-leaseback for purposes of the bill. As a further example, if property is owned by a corporation that is owned by a tax-exempt entity, a sale or other disposition of the stock of that corporation will be treated as a sale or other disposition of the property. Finally, property owned by a tax-exempt entity (or a related party) which is subsequently leased to the tax-exempt entity pursuant to one overall arrangement will be tax-exempt use property regardless of from whom the lessor obtained the property. For example, assume a tax-exempt entity sells a building to a taxable entity. The taxable entity sells or contributes the building to a partnership which, pursuant to one overall plan, leases it to the tax-exempt entity. The building is tax-exempt use property.

If a tax-exempt entity disposes of its ownership interest in a property before that property is placed in service by the tax-exempt entity (or a related party), the tax-exempt entity will not be treated as having transferred the property. For example, assume that a tax-exempt entity contracts to have a building constructed. Before the building is substantially completed, the tax-exempt entity assigns the construction contract to a taxpayer and agrees to lease the building from the taxpayer upon its completion. The property will not be treated as having been sold and leased back.

Lease term

For purposes of determining whether a lease has a term in excess of 80 percent of a building's remaining useful life at the time the lease is entered into, the building's then remaining useful life will be determined under the particular facts and circumstances.

Improvements

The bill provides that improvements to property (other than land) will not be treated as separate property, but only for purposes of determining whether there is tax-exempt use of property not owned by a tax-exempt entity. For example, if a governmental unit issues tax-exempt obligations, the proceeds of such issue are used by a taxpayer to acquire a building shell from a third party, and the taxpayer improves the building shell using other funds and leases the improved building to the governmental unit, the governmental unit will be treated as having participated in the tax-exempt financing of the entire property. Similarly, if a tax-exempt entity sells a building shell to a taxpayer and the taxpayer rehabilitates the building shell and leases the rehabilitated building back to the tax-exempt entity, the tax-exempt entity will be treated as using one property after a sale-leaseback.

On the other hand, if unimproved land is disposed of by a tax-exempt entity, a building is constructed on the land by the new owner, and the improved land is leased to the tax-exempt entity, the building will not be treated as having been the subject of a sale-leaseback.

Tax-exempt use property does not include improvements constructed by a taxable entity on underlying land or other property leased from a tax-exempt entity merely because the tax-exempt entity is the owner of the land or other property. For example, assume that a tax-exempt university leases land to a taxable entity for 45 years. The taxable entity constructs a building, which has an economic useful life of 40 years, on the land and leases it to a third-party taxpayer (or the university) for 30 years. The building is not tax-exempt use property. Similarly, assume that a municipality leases a certified historic structure to a taxable entity for 20 years. The taxable entity rehabilitates the structure in one year, using industrial revenue bonds, in a rehabilitation qualifying under section 48(g), converting it into a shopping mall. The rehabilitated mall is leased, piece-by-piece, to a variety of taxable merchants. No leasehold improvement is tax-exempt use property. However, the municipality is the tax owner of the building shell.

Other rules

A determination that there is a tax-exempt use of property does not require that the ultimate user of the property be a tax-exempt entity. A disqualified use at any point in a chain of use subjects the property to the bill. A similar rule applies with respect to the nontaxable use restriction of present law. For example, assume that a corporation constructs a new convention center and leases it to a city under an arrangement in which the city has a fixed price option to buy after 20 years. The city subleases or licenses the property to a variety of taxable entities that use it. The entire structure is tax-exempt use property.

Similarly, if a U.S. corporation leases equipment (e.g., a drilling rig) to a foreign corporation not subject to U.S. tax and the foreign corporation subleases the equipment to a Branch of a U.S. corporation, the property is tax-exempt use property even though all income earned by the U.S. branch with respect to the use of the property is subject to U.S. tax. (This result would not occur if, in view of the economic substance of the arrangements, the lease to and sublease by the foreign corporation was disregarded for U.S. tax purposes.) This result occurs without regard to the business reasons for the initial lease between the U.S. corporation and the foreign corporation.

Nor can a tax-exempt entity avoid the provisions of the bill merely by being a sublessee. Thus, if corporation A leases property to corporation B under a lease with a fixed price option and corporation B subleases the property to a tax-exempt entity, assigning its fixed price option to the tax-exempt entity, the property will be tax-exempt use property.

Whether the tax-exempt entity is the tax owner of the property will be determined under present law. For example, a tax-exempt entity may hold legal title to property, used by a taxable entity, as a security device in connection with an industrial revenue bond. If the tax-exempt entity is not the tax owner of the property, the mere fact that it has legal title will not cause the property to be treated as tax-exempt use property. *See* Rev. Rul. 68-590, 1968-2 C.B. 66.

Tax-exempt use property does not include any property or portion thereof predominantly used by a tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511.

4. Depreciation

General recovery period and method

In the case of tax-exempt use property, accelerated cost recovery deductions and any other deductions for depreciation or amortization are to be computed by using the straight-line method and disregarding salvage value. The recovery period for tax-exempt use property in the 15-year real property class is 40 years or 125 percent of the term of the lease, whichever is greater. The recovery period for all other tax-exempt use property is the mid-point life of the property as of January 1, 1981, under the ADR system, or 100 percent of the term of the lease, whichever is greater. Personal property that has no ADR life will be treated as having a mid-point life of 12 years. Property treated as leased to a tax-exempt entity under the bill's provisions for distinguishing service contracts and other arrangements from leases (see below) will be treated as leased to the tax-exempt entity for purposes of the bill's depreciation provisions.

Qualified technological equipment

The general depreciation provisions of the bill do not apply to "qualified technological equipment" (defined below) used by a tax-exempt entity pursuant to a lease with a term of 5 years or less. Except as indicated below, the cost (disregarding salvage value) of qualified technological equipment used by a tax-exempt entity pursuant to a lease with a term of more than 5 years is to be recovered using the straight-line method, a 5-year recovery period, and the half-year convention. Present law is retained for qualified technological equipment to which section 168(f)(2) (relating to recovery property used predominantly outside the United States) applies.

As with other property, whether qualified technological equipment purportedly leased to a tax-exempt entity is to be treated as owned for tax purposes by the tax-exempt entity will be determined under present law. For example, if qualified technological equipment with an economic useful life of 5 years is purportedly leased for 5 years, the nominal lessee may be treated as the tax owner of the equipment.

For purposes of the bill, qualified technological equipment consists only of computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment. Only tangible personal property can constitute qualified technological equipment.

Computers are programmable electronically activated devices capable of accepting information, applying prescribed processes to it, and supplying the results of those processes with or without human intervention. Computers consist of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. The term related peripheral equipment means auxiliary machines (whether on-line or off-line) designed to be placed under the control of the central processing unit of the computer. Neither term includes any equipment which is an integral part of property which is not a programmable computer, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment.

High technology telephone station equipment includes only property described in ADR class 48.13 and installed on a customer's premises. Furthermore, property described in ADR class 48.13 which does not have a high technology content does not qualify.

The term "high technology medical equipment" means any electronic, electromechnical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment. High technology medical equipment can include C.A.T. scanners, nuclear magnetic resonance equipment, clinical chemistry analyzers, drug monitors, diagnostic ultrasound scanners, nuclear cameras, radiographic and fluoroscopic systems, Holter monitors, and bedside monitors. Incidental use of any such equipment for other purposes, e.g., research, will not prevent it from qualifying as high technology hospital equipment.

For purposes of the rules regarding high technology telephone station equipment and high technology medical equipment, high technology equipment consists only of equipment which, because of a high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. For example, telephone booths and most telephones are not high technology equipment.

Qualified technological equipment does not include equipment which (1) is used by a tax-exempt entity after its disposition by the same tax-exempt entity (or a related party) if the tax-exempt entity (or a related party) used it before the disposition, (2) is financed with tax-exempt obligations, or (3) is used by the Federal government or a tax-exempt instrumentality thereof. Such equipment will be subject to the bill's general depreciation provisions.

The committee bill directs the Secretary of the Treasury to study whether the January 1, 1981, ADR mid-point lives for qualified technological equipment are inappropriate and to report the conclusions to Congress not later than July 1, 1984. The bill also grants Treasury authority to develop mid-point lives for any property that currently has no ADR life.

Operating rules

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period prescribed by the bill, then the cost of the property is to be recovered over the longer period. Property which would be 15-year real property if it were recovery property is treated as 15-year real property for purposes of the bill. For 15-year real property, first-year deductions are to be determined on the basis of the number of months in the year in which the property is in service. For other property, the half-year convention used under present law applies. For example, if the recovery period under the bill is 10 years, the cost recovery percentage will be 5 percent for the taxable year the property is placed in service by the taxpayer, 10 percent for each of the next 9 taxable years, and 5 percent for the eleventh taxable year.

Section 168(f)(12) of present law (relating to depreciation of certain property financed with industrial development bonds) is not to apply to property subject to one of the depreciation provisions of the bill.

The committee intends that regulations be promulgated under section 168(f)(13) (relating to changes in use of depreciable property) of present law to apply to property the tax ownership of which has not changed which either becomes or ceases to be tax-exempt use property some time after having been placed in service by the taxpayer.

5. Investment Tax Credit

As under present law, the investment credit (including the investment credit for energy property) generally will be denied for property (including qualified technological equipment) leased to or otherwise used by tax-exempt entities. The bill expands the category of tax-exempt entities subject to the nontaxable use restriction and provides statutory guidelines for distinguishing a service contract or other arrangement from a lease (see below). Property which becomes tax-exempt use property some time after having been placed in service will cease to be section 38 property at the time it becomes tax-exempt use property with the result that all or part of the investment credit may be recaptured. The present-law exception to the nontaxable use restriction for short-term or casual leases is retained for purposes of the investment tax credit.

Expenditures attributable to the rehabilitation of any portion of a building that is tax-exempt use property will not qualify for the rehabilitation credit if the expenditures are, or the cost of acquiring the building or any interest therein is, financed in whole or in part with the proceeds of tax-exempt obligations. However, the excluded expenditures will be taken into account under section 48(g)(1)(C) in determining whether there has been a substantial rehabilitation of the building. If rehabilitation expenditures are, or the cost of acquiring the building is, financed in whole or in part with the proceeds of tax-exempt obligations and all or a portion of the building becomes tax-exempt use property for the first time within 5 years, rehabilitation credits will be recaptured at that time as if that portion of the building which becomes tax-exempt use property had then been disposed of.

For example, assume that a taxpayer finances the $25,000 acquisition cost of a building with tax-exempt obligations. The taxpayer then spends $30,000 of its own money rehabilitating the building. One-third of the rehabilitated building is then leased to a tax-exempt entity under circumstances which make the one-third tax-exempt use property. No rehabilitation credit will be allowed on the $10,000 in rehabilitation expenditures attributable to that part of the building which is tax-exempt use property. However, a rehabilitation credit will be allowed on the other $20,000 in rehabilitation expenditures. If the other two-thirds of the building becomes tax-exempt use property within 5 years after the rehabilitation is completed, rehabilitation credits on the $20,000 will be recaptured.

6. Property Used Under Certain Service Contracts

The committee bill provides for the treatment of property used under a purported service contract arrangement with a tax-exempt entity as used by the tax-exempt entity if the arrangement is more properly characterized as a lease. That provision of the bill applies to contracts under which property is used to provide services to or for the benefit of a tax-exempt entity. The bill creates no inferences regarding the treatment of service contracts under present law. Nor does the bill affect the present-law rules for determining the treatment of management contracts under which a tax-exempt entity performs services with respect to property owned by a taxpayer.

The service contract provisions apply for purposes of the depreciation provisions of the bill and for purposes of the nontaxable use restriction on the investment credit (as modified by the bill). This provision applies to service contracts involving personal property or real property, whether the so-called service provider is the tax owner or the lessee of the property.

Factors to be considered

In determining whether a transaction structured as a service contract is more properly treated as a lease, the committee bill requires that all relevant factors be taken into account, including, but not limited to, whether (1) the tax-exempt entity is in physical possession of the property, (2) the tax-exempt entity controls the property, (3) the tax-exempt entity has a significant possessory or economic interest in the property, (4) the service provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (5) the service provider uses the property concurrently to provide services to other entities unrelated to the tax-exempt entity, and (6) the total contract price substantially exceeds the rental value of the property for the contract period.

Physical possession

Physical possession of property is indicative of a lease. Under the bill, property that is located on the premises of a tax-exempt entity, or located off the premises but operated by employees of a tax-exempt entity, is viewed as in the physical possession of the entity. However, property is not in the physical possession of a tax-exempt entity merely because the property is located on land leased to the service provider by the tax-exempt entity.

Control of the property

The fact that the tax-exempt entity controls the property is indicative of a lease. Under the bill, a tax-exempt entity is viewed as controlling the property to the extent the entity dictates or has a contractual right to dictate the manner in which the property is operated, maintained, or improved. Control is not established merely by reason of contractual provisions designed to enable the tax-exempt entity to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards.

Possessory or economic interest

A contract that conveys a significant possessory or economic interest to a tax-exempt entity resembles a lease. Under the bill, the existence of a possessory or economic interest in property is established by facts that show (1) the property's use is likely to be dedicated to the tax-exempt entity for a substantial portion of the useful life of the property, (2) the tax-exempt entity shares the risk that the property will decline in value, (3) the tax-exempt entity shares in any appreciation in the value of the property, (4) the tax-exempt entity shares in savings in the property's operating costs, or (5) the tax-exempt entity bears the risk of damage to or loss of the property.

Substantial risk of nonperformance

Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract. Under the bill, facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease.

Concurrent use of property

The concurrent use of the property to provide significant services to entities unrelated to the tax-exempt entity is indicative of a service contract.

Rental value of property relative to total contract price

The fact that the total contract price (including expenses to be reimbursed by the tax-exempt entity) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. If the total contract price reflects substantial costs that are attributable to items other than the use of the property subject to the contract, then the contract more closely resembles a service contract. Conversely, the fact that the total contract price is based principally on recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for use of property is indicative of a lease.

Other rules

A contract will be treated as a lease rather than a service contract if the contract more nearly resembles a lease. Although each of the factors in the bill must be considered, a particular factor or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of any single factor may not be dispositive in every case. For example, even if a tax-exempt entity does not have physical possession of property, the arrangement could still be treated as a lease after taking all other relevant factors into account.

Examples

The following examples illustrate the application of the service contract provisions of the committee bill. In each of these examples, T is a taxpayer and E is a tax-exempt entity.

Example (1)

E, an agency of the Federal government, desires to obtain the use of a built-to-purpose vessel. A contractor arranges for the construction of the vessel and for the sale of the vessel to T. The contractor then leases the vessel from T, the shipowner, under a long-term bareboat charter. E and the contractor enter into a time charter with respect to the vessel. The time charter provides for the transportation of equipment, cargo, and personnel. Under the time charter, E has the right to designate the port of call and the cargo to be carried. The master, officers, and crew of the vessel are hired by the contractor, subject to E's approval. All officers of the vessel must qualify for a government "confidential" security clearance. In addition, the master, chief officer, and radio officer must qualify for a government "secret" security clearance. E reserves the right to station 28 permanent government personnel aboard the vessel and to assign up to 100 additional military personnel to the vessel. However, the master of the vessel is under the direction of the contractor as regards navigation and care of the cargo. E also has the right to cause alterations to be made to the vessel. E must make separate payments for "Capital Hire" (computed by reference to the amount required to repay, with interest or a guaranteed return, the debt financing and equity investment of T) and "Operating Hire" (which covers the cost of operating the vessel and the contractor's profit). Payments of Operating Hire are suspended or reduced when the vessel is not fully available for service. However, E must continue to pay Capital Hire during such period.

The time charter has an initial term of 5 years. E has the option to extend on similar terms the basic term for one to four successive renewal periods, for a total of 25 years. The useful life of the vessel is in excess of 30 years. E can terminate the time charter for convenience at any time during the renewal periods. Upon a termination for convenience or if E fails to exercise a renewal option, E is required to pay any difference between the proceeds of the sale of the vessel and the "Termination Value" set forth in the time charter. The "Termination Value" is an amount approximating T's unrecovered equity, remaining debt service, and tax liability generated by the vessel's sale. E has the option to purchase the vessel at any time after the end of the basic 5-year term for the greater of fair market value or Termination Value at the time of purchase. If E purchases the vessel, E can require that the contractor continue to operate the vessel under the same terms as set forth in the time charter. If the vessel is damaged, destroyed, or otherwise lost due to causes beyond the contractor's control, E must pay any difference between Termination Value and any insurance proceeds. Thus, E also bears the risk of damage to or loss of the vessel.

E may be considered the owner of the vessel under the general principles for determining ownership for Federal income tax purposes. If, however, T were considered the owner, under the bill E would be treated as having a leasehold interest in the property (and the vessel would be tax-exempt use property). In the latter case, the following facts would serve as the basis for the conclusion that E is treated as having a leasehold interest: (a) E has some control over the vessel in that E can direct that alterations be made, (b) E has a significant possessory interest because the time charter contemplates that the vessel's use will be dedicated to E for a substantial portion of its useful life, the requirement that Termination Value be paid shifts the risk that the vessel will decline in value to E, and E bears the risk of damage to or loss of the vessel, (c) T does not bear a substantial risk of nonperformance within the meaning of the bill, because payments of Capital Hire continue even if the vessel is unavailable for service, (d) regarding the rental value of the property relative to the total contract price, the test for a service contract is not satisfied since the Capital Hire represents payments for the cost of the vessel and the Operating Hire represents separate payments for services, and (e) all other relevant facts and circumstances, including the facts that the vessel was built-to-purpose and the terms of E's purchase option. The facts that the contractor (and not E) has physical possession of the vessel and that there is no concurrent use of the vessel to provide services to other persons are insignificant in the context of this case

Example (2)

The facts are the same as in example (1) except that (a) E has no right to make alterations to the vessel, (b) E's obligation to pay charter hire is set at a rate per deadweight ton and is subject to the condition that the vessel be in full working order, (c) the time charter has an initial term of 5 years, with an option to renew for one to five one-year periods, for a total of 10 years, (d) T bears the risk of damage to or loss of the vessel, and (e) E has no option to purchase the vessel. In addition, E is not required to pay Termination Value (or any other penalty) if it fails to exercise a renewal option.

On these facts, the time charter will be respected as a service contract under the bill (and the vessel will not be tax-exempt use property). The following facts provide the basis for that conclusion: (a) E has no control over the vessel, (b) E has no possessory or economic interest in the vessel, (c) the contractor bears a substantial risk of nonperformance, since the contractor will receive no revenues if the vessel is unavailable for service, and (d) the facts do not indicate that any portion of the charter hire is based on the cost of the vessel.

Example (3)

E, a municipal housing authority, owns Section-8-assisted low-income housing projects. E sells the property to T, a partnership of taxable persons. In order to ensure that the purposes of the Section-8 housing program are fulfilled, T retains E to manage the property under a long-term management contract. Under the management contract, E performs many of the same managerial and administrative functions that it performed before the sale. However, T exercises a degree of control over E's activities, by virtue of provisions in the management contract that require E to keep adequate records of its operations, to use its best efforts to lease the housing units, and to pay net earnings to T within a reasonable time period. For these services, E is compensated by a fee determined on an arm's-length basis. T bears the risk that the property will decline in value and that the property will be damaged or lost. E does not have an option to repurchase the property.

The mere fact that E continues to control the maintenance and operation of the property under a management contract does not provide a basis for treating the contract as a lease under the service contract provision of the bill. However, the bill leaves open the possibility that an arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit) under present law rules. *See McNabb* v. *Commissioner*, 81-1 USTC 9143 (W.D. Wash. 1980) (where an arrangement structured as a management contract was characterized as a lease because the taxpayer did not adequately control the venture and did not bear the risk of loss); *Meagher* v. *Commissioner*, 36 T.C.M. 1091 (1977) (where the court held that an agreement was a management contract and not a lease, applying the same tests discussed in the *McNabb* case).

Example (4)

E, a municipal agency, acquires an industrial park and then leases the facility to T, a taxable person, for a term in excess of 15 years. T substantially rehabilitates the building, and then subleases the improved property to other taxable persons. T retains E to manage the property under a management contract.

T owns the improved portion of the building. The mere fact that E performs services with respect to the entire property under a management contract does not provide a basis for treating the improvements as tax-exempt use property under the service contract provision of the bill. Rather, the status of the management contract, as it relates to the leasehold improvements, is determined under present-law rules.

Example (5)

E, a municipality, and T, a private company, enter into a long-term agreement under which E will be the primary but not the only customer of a local district heating system (the System) that will be constructed, owned, operated, and maintained by T. A local district heating system consists of a pipeline or network which includes or is connected to a central heating source (such as a cogeneration facility or a solid waste resource recovery facility) that furnishes energy for heating through hot water or steam to two or more users for residential, commercial, or industrial heating or processing of steam. The System requires periodic maintenance and repair. The agreement between E and T provides for the distribution of BTUs to buildings owned by E. 40 to 75 percent of T's investment in the System will be allocable to the cost of pipeline, and the balance will be allocable to the cost of building or retrofitting a heating source. Approximately 97 percent of the pipeline included in the System is located off of E's premises. The only part of the System located on E's premises are pipes (for delivering the energy), meters (to measure E's usage), and heat exchangers. The in-building investment (attributable to pipes, meters, and heat-exchangers) may, in the case of some of the buildings owned by E, be made by E. In many cases, the only in-building investment made by T will be the cost of a meter. E will make monthly payments to T, determined by the amount of energy E consumes. T will also use much of the System to distribute BTUs to buildings owned by taxable persons in T's service area, under similar contracts.

On these facts, the agreement between E and T will not be treated as a lease. The following facts provide the basis for that conclusion: (a) E has physical possession of, at most, only a nominal part of the System, (b) E does not control the System, (c) T bears a substantial risk of nonperformance in that T will derive revenue from E based solely on the amount of energy E consumes, (d) T concurrently uses the System to provide energy to others, and (e) the System requires significant servicing by T. The fact that E has an economic or possessory interest in the property is, under the circumstances, outweighed by the other factors.

Example (6)

T, a private company, and E, a Federal governmental agency, enter into a contract under which T will construct and operate a solar energy system (the System). The System will be owned by a group of private investors. The System will be constructed on the roof of a building owned by E. All of the hot water and steam produced by the System will be sold to E under a long-term contract. E must pay a significant penalty if it defaults on the contract. However, T will receive no revenues under the contract unless the System produces energy. T is solely responsible for the operation and maintenance of the Facility. However, because the Facility is substantially maintenance free, the total contract price exceeds the rental value of the Facility by only 5 to 10 percent.

On these facts, the agreement between E and T is treated as a lease (and the System is tax-exempt use property) under the bill. That conclusion is based on the following facts: (a) E has physical possession of the System, (b) E has a possessory or economic interest in the System as the use of the property will be dedicated to E for the property's entire economic life, (c) there is no concurrent use of the property, and (d) the total contract price exceeds the rental value of the property by an insignificant amount. The facts that T controls the property and bears a risk of substantially diminished receipts do not provide a basis for a contrary conclusion because they have little meaning under the circumstances.

Special rules for qualified solid waste disposal facilities

The bill provides special rules for service contract arrangements involving qualified solid waste disposal facilities. A qualified solid waste disposal facility will be exempt from the depreciation provisions of the bill and the nontaxable use restriction on the investment credit. However, the special rules for service contracts involving qualified solid waste disposal facilities create no inferences regarding the treatment of property subject to the general service contract provisions.

The term "qualified solid waste disposal facility" is defined as any facility that (1) provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public, (2) generates marketable quantities of steam, hot water, or electricity, whether or not marketed, (3) is not controlled by or in the physical possession of a tax-exempt entity, and (4) with respect to which the service provider bears a risk of substantially diminished receipts or increased expenditures if there is nonperformance under the contract. For purposes of this rule, the general public includes commercial and other businesses, but only if the waste collected from such businesses is collected from them in their capacities as members of the general public (and not as members of a limited group such as a group that generates waste not processable by normal waste facilities serving the public).

Example (7)

E, a municipality, and T, a private company, enter into a solid waste disposal agreement under which T will construct, own, and operate a solid waste resource recovery facility (the Facility) on land leased from E. The Facility will process solid waste (of the type that is currently collected and disposed of as a part of normal municipal collections), generate steam, convert the steam to electricity, and recover ferrous metals from residual ash. T will invest 25 percent of the construction costs, and the balance will be financed with the proceeds of an issue of tax-exempt industrial development bonds to be issued by E. T will construct the project over a 3-year period and operate it for 20 years. Pursuant to a related energy purchase agreement, U, a utility unrelated to E, will be required to purchase a minimum amount of steam during each year of the same 20-year period. Absent default by T, E will pay an annual fee based on the greater of 400,000 tons of solid waste, regardless of whether such amount is actually delivered, or the number of tons of solid waste actually delivered. The fee is subject to a downward adjustment to reflect increases in T's energy revenues. T bears the primary risks of cost overruns, construction delays, and the possibility that the Facility will be unable to process the amount of waste or generate the amount of steam expected by the parties. Should the Facility be unavailable for service, T will be required to incur the expense of burying the solid waste delivered by E at a land fill site, at no extra charge to E.

E can terminate the agreement on performance grounds. In that event, E might obtain possession of the Facility until a new operator is found. In addition, E's employees may enter the Facility at any time to monitor and ensure T's compliance with contractual performance standards and environmental protection laws and regulations.

The Facility qualifies for the special service contract rule because (a) the solid waste disposed of is collected from the general public, (b) the Facility produces significant amounts of steam and electricity, (c) E is not viewed as controlling the property, notwithstanding the ability of E's employees to ensure that T complies with general performance and regulatory standards, (d) E is not in physical possession of the property, notwithstanding the contractual provision that would entitle E to possession until a new operator is found, and (e) T bears a substantial risk of nonperformance because of T's obligation to dispose of the waste delivered by E if the Facility is not operational and because T will lose revenue if the Facility fails to perform.

Treatment of partnerships and other pass-through entities and other arrangements

The committee is concerned that taxpayers and tax-exempt entities may attempt to structure transactions to avoid the restrictions of the bill. Transactions of this character might include the use of partnerships or other pass-through entities. To deal with those transactions, the bill contains two anti-abuse provisions.

First, a tax-exempt entity is treated as using its proportionate share of property that is held by a partnership of which the tax-exempt entity is a member, and its proportionate share of all income, gain, loss, deductions, and credits attributable to such property will be allocated to the tax-exempt entity. The determination of a tax-exempt entity's proportionate share is made on the basis of such entity's interest in the partnership's capital or profits, whichever basis results in the larger proportionate share. Where the application of the last sentence results in allocation of more than 100 percent of tax items, then allocation among partners will be made on a ratable basis. The bill provides for the application of similar rules to other pass-through entities (such as a trust).

The committee bill does not affect the present-law rule for determining the tax status of property that is co-owned by a tax-exempt entity under an arrangement that is not classified as a partnership for Federal tax purposes. Thus, a tax-exempt entity will continue to be viewed as owning a separate undivided interest in property held by a joint venture that is classified as a co-tenancy under Federal tax law. *See* Rev. Rul. 78-268, 1978-2 C.B. 10 (which addresses this issue in the context of applying the present law nontaxable use restriction on the investment credit).

Second, the committee bill provides that an arrangement other than a service contract (including but not limited to a partnership or other pass-through entity) with a tax-exempt entity (or a related party) that purports not to be a lease is to be treated as a lease if such arrangement is more properly treated as a lease. In determining whether any given arrangement is more properly treated as a lease, all relevant factors are taken into account, including factors similar to those set forth in the general service contract provisions. This provision is applicable to any arrangement, other than a service contract, under which a tax-exempt entity directly or indirectly obtains the use or benefits of property.

Example (8)

E, a not-for-profit hospital, and T, a partnership composed of individuals who are active members of E's medical staff, enter into a joint venture to acquire and operate a computer axial tomography (or "C.A.T.") scanner. The C.A.T. scanner will be used solely to aid in the diagnosis of diseases of E's patients. Each joint venturer will contribute equal amounts of debt and cash towards the purchase price of the property, and will share equally in net profits and losses and net cash flows. The C.A.T. scanner, which will be located on the premises of E, will be operated by members of T. The day-to-day business of the joint venture will be managed by a representative of each joint venturer. Under the joint venture agreement, T will be responsible for the billing of all technical charges and will receive two percent of gross charges for costs associated with preparing, mailing, and collecting charges. E will bill the joint venture and be reimbursed for occupancy costs (including utilities, housekeeping services, building depreciation, and interest) relating to the location of the C.A.T. scanner on its premises. The joint venturers will be separately responsible for interest, taxes, and insurance relating to participation in the joint venture. However, E is ultimately liable for the debt service obligations with respect to the entire property. The joint venture will terminate at the end of seven years. The useful life of the C.A.T. scanner is approximately nine years. Within six months of termination, T can require that E purchase T's interest in the joint venture at fair market value, adjusted upward if fair market value is less than a price specified in the contract (which price is computed by reference to the amount required to repay T's equity investment with a guaranteed return, less the net profits received by T during the term of the joint venture).

E is viewed as owning a separate undivided interest in at least 50 percent of the C.A.T. scanner, regardless of whether the joint venture is classified as a partnership or a co-tenancy for Federal tax purposes. Thus, E's interest in the property is tax-exempt use property under the general provisions of the bill, since E does not use the property in an unrelated trade or business the income from which is subject to tax. E will be allocated its proportionate share of all income, gain, loss, deductions, or credits attributable to the C.A.T. scanner. The joint venture agreement is also subject to the provision of the bill relating to arrangements other than service contracts that purport not to be leases, insofar as such agreement relates to T's interest in the property.

Furthermore, the property, by being used for E's patients, is being used for the benefit of E. Under the bill, taking into account factors similar to those enumerated in the general service contract provision, the arrangement is treated as conveying to E a leasehold interest in T's interest in the property. Thus, the entire property is tax-exempt use property. The following facts provide the basis for this conclusion: (a) although no payments are required to be made by E to T, T will be compensated through payments made by E's patients and by the terms of the put, (b) E has control of T's interest in the property because E has an equal voice in the operation and maintenance of the entire property, (c) E has a possessory interest in T's interest because the property will be used under the agreement for a substantial portion of the property's useful life and E bears the risk that the property will decline in value by virtue of the put held by T, (d) T does not have the right to use the property to provide services to anyone other than a patient of E, and (e) all other relevant facts, including the facts that the use of the property is integrally related to E's tax-exempt function, that E has guaranteed the repayment of the total acquisition indebtedness, and that the property will be operated only by E's employees. Given the totality of the facts and circumstances, the fact that T bears a risk of substantially diminished receipts is mitigated by E's obligation to fulfill T's debt service requirements and does not provide a basis for a contrary conclusion.

Because the C.A.T. scanner qualifies for the exemption for qualified technological equipment, the cost of T's interest is recovered over 5 years. However, the C.A.T. scanner is ineligible for the investment credit.

7. Short-Term Lease Exception

Property subject to a short-term lease to a tax-exempt entity will not be treated as tax-exempt use property under the depreciation provisions of the bill. For purposes of this rule, the term of a lease begins when property is first used under it. In the case of property other than 15-year real property, a lease of less than 1 year or 30 percent of the property's ADR mid-point life (but not greater than 3 years), whichever is greater, will qualify as a short-term lease. In applying the bill's depreciation provisions with respect to 15-year real property, a lease of less than 3 years will qualify as a short-term lease. In determining whether any portion of a rehabilitated building is tax-exempt use property, for purposes of computing qualified rehabilitation expenditures, a lease of less than 1 year will qualify as a short-term lease. For example, assume that all of a qualified rehabilitated building financed with tax-exempt obligations is leased for 2 years to a tax-exempt entity that participated in the financing. No rehabilitation credit will be allowed, but the depreciation provisions of the bill will not be applicable.

8. Lease Term

For all purposes of the bill, the term of a lease includes all periods for which the tax-exempt lessee (or a related party) has a legally enforceable option to renew, or the lessor has a legally enforceable option to compel renewal by the tax-exempt entity (or a related party), whether the lease is in fact renewed and regardless of the terms at which the lease is renewable. The bill also leaves open the possibility, as under present law, that the term of a subsequent lease could be included in the term of the original lease if the circumstances indicate that the parties, upon executing the original lease, had informally agreed that there would be an extension of the original lease. An extension at a rental rate differing materially from the market rental rate at the time of the extension would suggest that the parties had such an informal agreement.

Also, the bill measures the lease term by counting successive leases as one lease. This rule applies if the original lease and one or more successive leases are entered into contemporaneously. The successive lease rule will not apply merely because the parties enter into a new lease at fair rental value at the end of the primary lease term.

9. Definition of Related Party

The following related party rules apply under the bill:

Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality the rights, powers, and duties of which derive in whole or in part, directly or indirectly, from the same sovereign authority. Therefore, a multi-State commission is related to each of its member States, since the commission will be deriving its authority from those States. For purposes of this rule, the United States, each State (including the District of Columbia), each possession of the United States (including Puerto Rico), and each foreign country is a separate sovereign authority. Therefore, a city in one State will not be related to a city in another State under the rule. However, each city in a foreign country will be treated as related to every other governmental unit, agency, or instrumentality in that foreign country.

Any entity (other than a governmental unit or an agency or instrumentality of such a unit) is related to any other person if the two have (a) significant common purposes and substantial common membership or (b) directly or indirectly, substantial common direction. For example, the local chapter of a national fraternity or of the Red Cross is related to its national organization.

Any tax-exempt entity is related to any other entity if either owns 50 percent or more of the capital interests or the profit interests in the other. For example, a foreign person is related to its wholly-owned subsidiary and any corporation that owns 50 percent or more of the value of its stock, and a section 501(c)(3) organization is related to any corporation 50 percent or more of the stock of which it owns. For purposes of this rule, an entity treated as related to any other entity under either of the two foregoing rules will be treated as the one entity. For example, assume that each of 10 cities within 1 State own 10 percent of a corporation. The State, each city and the corporation are related parties.

Any tax-exempt entity is related to any other tax-exempt entity with respect to a particular transaction if such transaction is part of an attempt to avoid the application of the bill.

10. Exceptions

The bill does not apply to mass commuting vehicles exempted from most of TEFRA's amendments to the safe harbor lease provisions. See section 208(d)(5) of P.L. 97-248. Furthermore, the bill does not apply to property described in section 208(d)(3)(E) of P.L. 97-248, as amended by P.L. 97-448 (relating to certain boilers and turbines of rural electric cooperatives). Nor does the bill apply to property described in section 168(f)(12)(C)(ii) (relating to certain sewage or solid waste disposal facilities) of present law if a ruling request relating to the tax consequences of the use of such property by a tax-exempt entity was filed on or before May 23, 1983.

The committee bill does not apply to any motion picture film or video tape described in section 48(k)(1)(B) (relating to motion picture films and video tapes created primarily for public entertainment or educational purposes) used by any foreign person or entity. However, no inference is intended as to whether motion picture films and video tapes can qualify as recovery property.

11. Regulations

The bill provides that the Secretary is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of new section 168(j). However, no such regulations are to be inconsistent with the bill, as reflected in its legislative history.

D. Effective Date

General

The bill applies to property placed in service by the taxpayer after May 23, 1983, except to the extent acquired by the taxpayer subject to a lease in effect on May 23, 1983. The bill also applies to property placed in service by the taxpayer before May 24, 1983, and used pursuant to a lease entered into or renewed after May 23, 1983. For purposes of the preceding sentence, a lease will not be treated as entered into or renewed after May 23, 1983, merely by reason of the exercise by a lessee of a written option, or performance under a contract, enforceable against the lessor on May 23, 1983, and at all times thereafter. Furthermore, property will not become tax-exempt use property merely because a lessee under a lease entered into before May 24, 1983, subleases to a tax-exempt entity after May 23, 1983.

Transitional rules

The bill has three effective date transitional rules.

First transitional rule

Under the first transitional rule, the bill does not apply to property used by a tax-exempt entity pursuant to one or more written contracts binding on May 23, 1983, and at all times thereafter, which required the taxpayer (or a predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate the property and the tax-exempt entity (or a tax-exempt predecessor in interest under the contract) to use the property.

For example, assume that on February 1, 1983, a tax-exempt entity enters into a binding contract to have a building constructed. Construction is to be completed on January 15, 1984. On May 1, 1983, the tax-exempt entity assigns its interest in the construction contract to corporation X and enters into a binding contract to lease the building back from corporation X upon its completion. The first transitional rule applies. However, the first transitional rule would not apply if the assignment and entering into of the binding contract to lease did not occur until after May 23, 1983.

As a further example, assume that a tax-exempt entity has owned and occupied all of a building for years. On May 1, 1983, the tax-exempt entity enters into a binding contract with corporation Y pursuant to which the tax-exempt entity, on July 1, 1983, will sell the building to corporation Y and lease it back. The first transitional rule applies. The result would be the same even if corporation Y assigns its entire interest in the contract to corporation Z, or contributes it to a partnership of which it is a member, on June 1, 1983. And the result would be the same if the tax-exempt entity assigned its interest in the lease to another tax-exempt entity on June 15, 1983.

A contract is binding only if it is enforceable under State law against the taxpayer (or a predecessor) and does not limit damages to a specified amount as, for example, by a liquidated damages provision. A contract that limits damages to an amount equal to at least 5.0 percent of the total contract price will not be treated as limiting damages. A contract is binding even if subject to a condition, so long as the condition is not within the control of either party (or a predecessor). A contract will not be treated as ceasing to be binding merely because the parties make insubstantial changes in its terms or if any term is to be determined by a standard beyond the control of either party. Finally, a contract which imposes significant obligations on the taxpayer (or a predecessor) will not be treated as non-binding merely because some terms remain to be negotiated. For example, if a corporation and a tax-exempt entity enter into a legally enforceable contract on May 1, 1983, pursuant to which the corporation agrees to buy a building from the tax-exempt entity and then lease it back, the contract will be treated as a binding contract to use notwithstanding the fact that some terms of the lease have not yet been set.

On the other hand, a binding contract to acquire a component part for a larger piece of property will not be treated as a binding contract to acquire the larger piece of property. For example, if a tax-exempt entity entered into a binding contract on May 1, 1983, to acquire a new aircraft engine, there would be a binding contract to acquire only the engine, not the entire aircraft.

Second transitional rule

Under the second transitional rule, the bill does not apply to property (a) which the taxpayer (or a predecessor in interest under or in the contract) or the tax-exempt entity was required to acquire, construct, reconstruct, or rehabilitate pursuant to a contract that was binding on May 23, 1983, or has commenced but not completed construction, reconstruction, or rehabilitation by May 23, 1983, if (b) the tax-exempt entity either (i) by December 31, 1983, enters into a binding contract to use the property or (ii) had, on May 23, 1983, and at all times thereafter, a firm plan, evidenced in writing, to enter into a contract for its use. Requirement (a) above will not be satisfied if the tax-exempt entity (or a related party) used the property before May 24, 1983, except that property acquired before May 24, 1983, and after December 31, 1982, or property the construction, reconstruction, or rehabilitation of which is completed after December 31, 1982, and before May 24, 1983, will be treated as meeting that requirement. Property does not fail the completion-of-construction test merely because a certificate of completion was not issued.

For example, assume that a tax-exempt entity acquires and begins using a building on November 1, 1982. On February 1, 1983, the tax-exempt entity enters into a binding contract to have the building rehabilitated. The rehabilitation is to be started on March 1, 1983, and completed by May 1, 1984. By May 1, 1983, the tax-exempt entity has a firm plan, evidenced in writing, to enter into a sale-leaseback of both the original building and the rehabilitation. On January 15, 1984, pursuant to the firm plan, a binding agreement to sell and lease back is entered into. On these facts, the second transitional rule applies to the rehabilitation but not to the original building (since it was acquired and used before January 1, 1983). Assuming the requirement in (a) above was satisfied, the same result would follow even if the tax-exempt entity had no firm plan to do a sale-leaseback prior to May 24, 1983, if a binding sale-leaseback agreement is entered into before the end of 1983. If the tax-exempt did not acquire and use the building until January 15, 1983, the second transitional rule would apply to it as well.

For purposes of this transitional rule, the contract to acquire, construct, reconstruct, or rehabilitate need not be with the seller or the construction company. It is sufficient if the taxpayer (or a predecessor) or the tax-exempt entity has a contract with any person requiring the taxpayer (or a predecessor) or the tax-exempt entity to acquire, construct, reconstruct, or rehabilitate. For example, a binding contract between a taxpayer and a tax-exempt entity pursuant to which the taxpayer is obligated to have property constructed for the tax-exempt entity qualifies as a binding contract for purposes of the second transitional rule. The other rules applicable under the first transitional rule with respect to assignments of contracts and binding contracts are equally applicable under the second transitional rule.

A firm plan to enter into a contract for the use of property exists if the tax-exempt entity had planned to contract for the use of the property and, under all the circumstances, it was reasonable to expect that the tax-exempt entity or a successor tax-exempt entity would in fact enter into a contract to use the property. A firm plan would not be treated as existing if the tax-exempt entity merely retained professional advisors to advise it, generally or with respect to a particular transaction, even if such advisor had recommended that the tax-exempt entity lease the property involved. A firm plan would exist, however, if the governing body of the tax-exempt entity, its chief executive, any other person authorized to speak for it, or its paid professional staff approved the recommendation and it was reasonable to expect the tax-exempt entity to enter into a contract for the use of the property involved in the recommendation. A firm plan would also exist if the tax-exempt entity historically entered into contracts for the use of similar property, absent indications to the contrary. For example, assume that a foreign airline contracts to have aircraft manufactured for it, with completion scheduled for 1985. The foreign airline has leased the last 5 planes manufactured for it, and there are no indications that the new planes will not also be leased. The foreign airline has a firm plan.

Satisfactory written evidence of a firm plan would include minutes of meetings, written correspondence from representatives of the tax-exempt entity, letters of intent executed by the tax-exempt entity, written solicitation of proposals from the tax-exempt entity to prospective lessors, and, in the case of a firm plan purportedly based on custom, written evidence of the historical practices relied upon. If a firm plan existed on May 23, 1983, it would be in all events treated as continuing through the date of enactment.

Third transitional rule

Under the third transitional rule, the bill does not apply to property constituting part of a project which was approved by significant official governmental action on or before May 23, 1983, and with respect to which significant sums were paid or incurred on or before May 23, 1983, so long as the tax-exempt entity by December 31, 1983, enters into a binding contract to use the property. For purposes of this rule, significant official governmental action approving design work for a project will be treated as significant official governmental action approving the project. The third transitional rule cannot apply if the tax-exempt user of the property is the Federal government, any agency or instrumentality thereof, or a foreign person but can apply if the tax-exempt user is a State or local government unit or any other tax-exempt entity.

For example, assume that prior to May 24, 1983, a city council approved a plan providing for the rehabilitation of city hall. Also prior to May 24, 1983, the city expended significant funds for architectural services with respect to the rehabilitation. On December 1, 1983, the city enters into a binding contract to sell the rehabilitated city hall to private investors and lease it back. Prior to May 24, 1983, the city had no plan to sell the building and lease it back.

The third transitional rule is applicable with respect to the entire building, as rehabilitated.

For purposes of the third transitional rule, whether particular property is part of an approved project, or a project for which design work had been approved, depends on all the facts and circumstances, including the tax-exempt entity's plans on May 23, 1983.

The payment or incurrence, by the taxpayer, the tax-exempt entity, a related party, any predecessor of any of the foregoing, or any governmental unit or other participant in the project of sums equal to the lesser of $100,000 or .5 percent of the estimated cost of a project would be treated as the payment or incurrence of significant sums. A binding obligation, conditioned only on the performance of services by a third party, to expend sums will be treated as an expenditure of such sums. Sums paid or committed to independent third parties, including out-of-pocket expenditures, will be counted for purposes of this rule, but amounts paid or incurred with respect to the tax-exempt entity's staff, other employees, or general overhead allocable to the project or its design work will not. Sums will be considered expended notwithstanding the fact that reimbursement might be made by the lessor or some other party. Sums will also be considered incurred notwithstanding the fact that liability contingent on substantial completion of the project involved.

A project (or design work with respect to a project) will be considered as having been approved by significant official governmental action if the governing body having authority to commit the tax-exempt entity to the project (or the design work), to provide funds for it, or to approve the project (or the design work) under State or local law took significant action indicating an intent to proceed with, provides funds for, or approve the project (or the design work) and it would be reasonable, under all the circumstances, to expect that the project (or the design work) would be carried out. As an example, assume that in December, 1982, the State agency regulating hospitals in the State issues a certificate of need to a tax-exempt entity with respect to a specific hospital project. The official governmental action rule is satisfied.

The significant official governmental action rule contains three separate requirements. First, the action must be an official action. Second, the action must be specific action approving a particular project. And third, the action must be taken by a governing body having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under State or local law.

Under the first requirement, the governing body must adopt a resolution or ordinance, or take similar official action, prior to May 24, 1983. The action qualifies only if it conforms with Federal, State or local law and is a proper exercise of the powers of the governing body. Moreover, the action must not have been withdrawn. Finally, written evidence of the action must have existed before May 24, 1983. Satisfactory written evidence includes a formal resolution or ordinance, minutes of meetings, and contracts with third parties pursuant to which the third parties are to render services in furtherance of the project.

The second requirement is directed at the substance of the action taken. The action must be a specific action with respect to a particular project in which the governing body indicates an intent to have the project (or the design work for it) proceed. This requires that a specific project have been formulated and that the significant official action be a step toward consummation of the project. If the action does not relate to a specific project or merely directs that a proposal or recommendation be formulated, it will not qualify. On the other hand, no plan to lease needs to have been formulated by May 23, 1983. Generally, a significant official action would include the hiring of bond counsel or bond underwriters necessary to assist in the issuance and sale of bonds to finance a particular project or the adoption of an inducement resolution relating to bonds to be issued for such a project. It would also include making application for an Urban Development Action Grant on behalf of the project described in the application or receipt of a governmental grant with respect to the project. It would also include the recommendation of a city planning authority to proceed with a project based on the results of an authorized feasibility study.

Under the third requirement, the action must be taken by a governing body (Federal, state, or local) having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under applicable law. If the chief executive or another representative of a governing body has such authority, action by such representative would satisfy the official governmental action requirement so long as it qualified as official action and related to a particular project, regardless of whether such action might later be rescinded. A governing body may have the authority to commit the tax-exempt entity to a project notwithstanding the fact that the project cannot be consummated without other governmental action being taken. For example, a city council will be treated as having authority to commit a city to do a sale-leaseback of its city hall notwithstanding the fact that State law needs to be amended to permit such a transaction. Similarly, if a local project cannot be completed without Federal approval, either legislative or administrative, the obtaining of such approval will qualify as official governmental action.

However, routine governmental action at a local level will not qualify as official governmental action. Routine governmental action includes the granting of building permits or zoning changes and the issuance of environmental impact statements.

Certain waste water treatment facilities

Waste water treatment facilities which are used by a tax-exempt entity and which are not 15-year real property are to be depreciated on the straight-line method over 12 years, using the half-year convention and disregarding salvage value, if, by June 15, 1983, a city council approved entering into a lease and, by July 12, 1983, a resolution was adopted approving the issuance of industrial development bonds to finance acquisition of the facilities by the taxpayer.

E. Revenue Effect

The provision will increase fiscal year budget receipts by $683 million in 1984, $990 million in 1985, $1,740 million in 1986, $3,070 million in 1987, and $4,877 million in 1988.

TITLE II—LIFE INSURANCE TAX ACT OF 1983

A. Present Law

1. Pre-1959 Taxation of Life Insurance Companies

Before 1921, insurance companies were taxed in substantially the same manner as other corporate entities. Under the Revenue Act of 1921 and subsequent legislation, however, life insurance companies were accorded special tax treatment.

From 1921 through 1957, a life insurance company was only taxed on investment income. Premiums were excluded from the income computation, as were losses and expenses incurred in underwriting operations, and gains and losses from the sale of investment assets. In addition, various formulae were established to exclude from taxation the portion of investment income necessary to satisfy the company's obligations to policyholders under its insurance contracts and, though the formulae varied from time to time, their purpose was always to compute that portion of investment income allocable to policyholders. This approach of taxing income only to the extent not needed to fund current and projected liabilities to policyholders as determined under State law has been referred to as taxing a company on its free investment income.

2. The 1959 Act

In general

The general framework under which life insurance companies are taxed under present law was adopted in the Life Insurance Company Income Tax Act of 1959 (secs. 801–820 of the Code).[1] The 1959 Act significantly changed prior law by attempting to measure the total income of a life insurance company rather than just it's free investment income. Nonetheless, as described below, under the 1959 Act various deductions and "special rules" resulted in an income tax base which fell short of total income.

Computing taxable income

Under the 1959 Act, a life insurance company is taxed on the lesser of its taxable investment income or its gain from operations. If a company's gain from operations exceeds its taxable investment income, the company is taxed on 50 percent of such excess. The tax with respect to the other half of the excess of gain from operations over taxable investment income is deferred; that half (along with amounts deducted for nonparticipating contracts, accident and health and group life insurance contracts) is added to a deferred tax account (policyholders' surplus account) and, subject to certain limitations, is taxed only when distributed to shareholders of a stock company. Thus, under the 1959 Act, a life insurance company must compute its gain (or loss) from operations and its taxable investment income. The computation of gain from operations begins with the company's total income including the company's share of investment yield,[2] net capital gain, premiums and other considerations, decreases in insurance reserves, and all other amounts. From this total, a life insurance company is allowed deductions. These generally include the usual deductions available to taxpayers for business or investment expenses, an operations loss deduction, and certain deductions unique to the insurance business such as for payments of claims and death benefits, for increases in reserves (to the extent not funded out of the policyholders' share of investment income), and for certain payments under assumption reinsurance. All life insurance companies are also permitted to claim a small business deduction. Finally, there are three special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts, which are subject to limitations. Unlike the deduction for policyholder dividends, the other two special deductions do not reflect actual cash expenditures by the company or even the commitment of funds to a reserve required under State law.

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[1] Public Law 86-69, June 25, 1959. The Act was generally effective for taxable years beginning after December 31, 1957.

In addition, a deduction is allowed for the company's allocable share of tax-exempt income and the amount of any dividends received by the company that are deductible under provisions generally applicable to all corporations. The initial inclusion of tax-exempt income followed by the later deduction of the company's share has the effect of allocating a portion of tax-exempt income to the policyholders' share which is not includible in the company's taxable income in any event. Thus, tax-exempt income is not as attractive to life insurance companies as to other taxpayers as a means of reducing their effective tax rate.

To compute taxable investment income, it is necessary to calculate investment yield. Investment yield is the excess of gross investment income over all applicable investment expenses. Then, the policyholders' share of investment yield is excluded.[3] Finally, the company may deduct from its share of investment yield its share of tax-exempt investment income and of the deduction for dividends received.

Under the 1959 Act and present law, the computation of a life insurance company's taxable investment income is important for two purposes. First, as discussed above, a company may be taxed on its taxable investment income. Second, for purposes of computing gain from operations, the aggregate amount allowed for the special deductions is limited by reference to the amount of the company's taxable investment income. Prior to amendment in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA), the 1959 Act provided that the amount of deductions allowed for policyholder dividends, for nonparticipating contracts, and for accident and health and group life insurance contracts be limited to the amount by which gain from operations (before those deductions) exceeded taxable investment income, plus $250,000. This limitation was designed to ensure that most large companies be subject to tax at least on their free investment income (reduced by no more than $250,000). As explained beow, this $250,000 statutory amount was modified in TEFRA.

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[2] The computation actually begins with gross investment income, less investment expenses, from which the interest contractually required to be set aside for policyholders is excluded. A portion of an item required to be set aside for policyholders is referred to as the policyholders' share of such item. The excess of the amount of the item over the policyholders' share is the company's share.

[3] Under the taxable investment income computation, the policyholders' share of investment yield is determined in part by use of the "Menge formula," which arithmetically adjusts State required life insurance reserves to allow the crediting of earnings at an adjusted rate that takes into account the actual earnings rate of the individual companies. In general, the effect of this computation is to allocate to the policyholder an amount at least equal to the reserves required under State law (unless under the permanent provisions, the current earnings of the company exceed 10 percent). The 1959 Act does not establish a Federal standard for computation of reserves or require that they be based on a company's actual experience.

Tax phases

The provisions described above for computing a life insurance company's taxable income require a comparison of the company's taxable investment income and its gain from operations. Depending on the mix of these elements, two companies with the same aggregate pre-tax income may owe different amounts of tax. The result is that most life insurance companies can be classified on the basis of the mix of investment income and underwriting gain as being in one of three tax phases.

Phase I Company

Under the 1959 Act, a Phase I company has a gain from operations that is less than its taxable investment income, and has reached the limit on the deduction for policyholder dividends and certain other amounts. A life insurance company that would typically be in this phase is an established mutual company, which might have substantial underwriting income before any policyholder dividend distributions. This company could use the deduction for policyholder dividends to reduce gain from operations.

Phase II (Positive) Company

A Phase II (Positive) company has a gain from operations in excess of its taxable investment income taking into account any policyholder dividends. A typical life insurance company taxed under this phase would be an established stock company which has no State law requirement to share favorable investment and underwriting experience with its policyholders through policyholder dividends. A Phase II (Positive) company's taxable income is generally the sum of its taxable investment income, and one-half of the excess of its gain from operations over taxable investment income. Because a company's gain from operations is roughly the sum of its taxable investment income and its underwriting gain, a Phase II (Positive) company is taxed currently on one-half of its underwriting gain while the other half becomes part of the policyholders' surplus account (known generally as the Phase III account).

Phase II (Negative) Company

A Phase II (Negative) company has a gain from operations that is less than its taxable investment income by more than $250,000 (under the 1959 Act) because of underwriting losses. Typically, a

Phase II (Negative) company is a new or growing stock life insurance company that has underwriting losses from its insurance business because start-up costs associated with new insurance business are high in proportion to its total insurance business. In such a case, taxable investment income is reduced by the expenses of operating the company because the underwriting income alone is not sufficient to cover the costs of the insurance business. A Phase II (Negative) company's taxable income is its entire gain from operations.[4]

3. TEFRA Changes

Under TEFRA, Congress addressed certain tax avoidance techniques. TEFRA contained both permanent provisions and temporary provisions (effective, generally, for 1982 and 1983) to allow a more thorough Congressional review of the tax laws applicable to life insurance companies and their products.

Modco and reinsurance

Provisions governing modified coinsurance transactions were permanently repealed. In addition, provisions were adopted to prevent abuse through dividend reimbursement agreements between insurance companies engaged in reinsurance transactions. Further, provisions were added to deny deductions for interest paid on indebtedness used in reinsurance transactions, and to grant Treasury special income allocation and recharacterization authority with respect to reinsurance transactions between related parties. TEFRA provided in addition that for years before 1982 (except in the case of fraud) the determination of whether a reinsurance contract satisfied the modified coinsurance requirements of then existing law would be made solely by reference to the terms of the contract.

Special deductions

TEFRA adopted a temporary change in the limitation on the special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts. This provision generally raised the $250,000 statutory dollar amount under the 1959 Act to $1 million, but targeted it to small life insurance companies.

TEFRA also provided an alternative limitation on the special deductions. Under this provision, the maximum amount that can be deducted is the sum of (1) 100 percent of policyholder dividends on pension contracts, (2) the statutory amount , and (3) 85 percent (77-1/2 percent for mutual companies) of the tentative deduction for policyholder dividends, other than policyholder dividends on pension business. For most companies, this alternative is substantially more generous than the limitation provided under the 1959 Act.

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[4] In addition to the three tax phases discussed above, there is also a "Phase I Corridor" company, which is taxed on its entire gain from operations that is less than taxable investment income by an amount less than $250,000 (under the 1959 Act), and a "Phase III" company, which has taxable income that includes shareholder distributions of, or subtractions from, previously tax-deferred amounts from the policyholders' surplus account.

Computation of reserves

TEFRA contained a number of temporary provisions relating to the computation of reserves. First, interest guaranteed in a contract in excess of the interest that would be earned at the rate assumed for purposes of computing statutory reserves cannot be taken into account in computing the reserves to the extent such excess interest is guaranteed beyond the taxable year. Second, under TEFRA, the amount of investment yield that can be allocated to group pension contracts is limited to the amount actually credited to such contracts. Both of these provisions have the practical effect of reducing the exclusion for the policyholders' share of investment yield. Third, under TEFRA, the status of a life insurance company cannot be changed because of its reserve treatment of group pension funds. This prevents reclassification for tax purposes of life insurance companies as casualty insurance companies—which would be adverse to certain stock companies and favorable for certain mutual companies—because they have removed life contingencies from pension contracts. Fourth, an arithmetic adjustment to reserves contained in the 1959 Act (the Menge formula) was changed to a geometric adjustment, allowing a slightly more generous policyholders' share of investment yield. In addition to these temporary changes, there was a permanent reduction in the amount allowed a life insurance company under the approximate formula for revaluing preliminary term reserves for insurance other than term life insurance. Under TEFRA, reserves are increased by $19 per $1,000 of insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 reduced by 2.1 percent, as under prior law).

Consolidated returns

Under a temporary provision, related life insurance companies are allowed to compute their respective taxable incomes before consolidation (a bottom-line method). This method is allowed instead of requiring consolidation of income items before computing consolidated taxable income (a phase-by-phase method).

Annuities

TEFRA also contained permanent changes for the tax treatment of annuity contracts to companies and to policyholders. In general, companies are allowed the full deduction for amounts credited to annuity contracts. For a policyholder, cash distributions from an annuity contract before the annuity starting date are taxable to the policyholder to the extent there is income in the contract. Also, if a portion of such an income distribution is attributed to an investment in the contract that was made within 10 years of the distribution, there is a 5-percent penalty tax on such portion. There are, however, a number of exceptions to this rule; for example, no penalty applies to income distributions on or after the policyholder reaches age 59-1/2.

Flexible premium life insurance

Finally, TEFRA adopted temporary guidelines with respect to flexible premium life insurance contracts (i.e., universal life and adjustable life), which must be met in order for the death proceeds from such contracts to be considered life insurance for tax purposes.

B. Reasons for Change

Overview

The changes in the tax treatment of life insurance companies, products, and policyholders in the bill are the result of a lengthy study by the committee and one of its subcommittees. During the course of the study it became apparent that, as a result of two factors, changes are required. The first factor is the unusually large increase in interest rates that has occured since 1959. The second is Congress' desire to simplify the Code and eliminate the extraordinarily complex three-phase tax structure of present law.

Rising interest rates have caused several changes in the tax position of the life insurance companies since the enactment of the 1959 Act. First, with rising interest rates increasing investment income the tax liability of mutual (and, to a lesser extent, stock) insurance companies began to increase. Second, these companies made extensive efforts to reduce their increasing Federal income tax liability by entering into larger volumes of modified coinsurance transactions by which investment income was recharacterized as underwriting income. In 1981, one of the largest mutual companies used modified coinsurance so extensively that it reduced its tax to zero. Third, some stock companies, in order to compete with other financial intermediaries, began to offer investment-oriented products that, in effect, allowed them to distribute currently high investment yields tax-free to policyholders. Mutual companies were slower to enter this market because their ability to pay policyholder dividends already permitted them to pass through to policyholders favorable investment experience, although some of those dividends were taxed at the company level because of the limitation on the deduction for policyholder dividends.

In 1982, the Congress responded to these changes in the life insurance industry through a number of tax changes including a permanent repeal of the provisions for the special tax treatment of modified coinsurance. At that time it was estimated that the repeal of modco would increase revenues by $2.3 billion in 1982 over an estimated prior law tax burden of $1.7 billion. Concern over the effect of so substantial a change in tax burdens led to enactment of a series of temporary provisions which generally had the effect of reducing the industry tax burden by an estimated $1.2 billion for 1982 and by the same amount for 1983. These provisions will expire at the end of 1983.

Inadequacies of the 1959 Act

In reviewing the 1959 Act, the committee identified numerous inadequacies. First, drafted in the middle of a period of low and stable interest rates, the 1959 Act distinguishes between investment and underwriting income and taxes them differently. While interest rates remained stable, the 1959 Act functioned reasonably well, although it never taxed companies on their full economic income. With recent increases in interest rates and the evolution of new insurance products, however, the 1959 Act results in an inappropriate measure of life insurance company income. As a result, the committee concluded that a proper measure of the income of life insurance companies can be obtained only by replacing the complex, three-phase structure of present law with a simpler, single-phase tax.

A second inadequacy of the 1959 Act which the committee identified is that the Act includes a variety of deductions and deferral items that do not relate to a proper measure of a life insurance company's income and which provide extraordinary benefits for some companies and no benefits for other companies. In particular, the special deductions for accident and health insurance and for nonparticipating policies bear no relationship to actual expenditures by companies and tend to benefit mature stock companies more than other companies. Similarly, the deferral of tax on underwriting income is, in effect, beneficial only to certain stock life insurance companies. The revaluation of reserves from amounts computed under a preliminary term method to amounts computed under a net level premium method allows a deduction for amounts that are not, in fact, added to reserves and tends to benefit primarily expanding, newer, stock life insurance companies. Finally, the rules relating to deduction of policyholder dividends, which primarily affect mutual companies, operate to assure that companies are taxed on at least their investment income. These rules do not attempt to distinguish between amounts returned to policyholders as customers and amounts distributed to them as owners of the mutual company. As a result, a mutual company may be taxed on a base that is either greater than or less than its economic income.

A third concern with respect to the 1959 Act relates to the tax treatment of reserves maintained by life insurance companies. Under present law, a company's reserves are based on its statutory reserves, which are computed using assumptions under State law. The result is a significant overstatement of liabilities in comparison to those measured under realistic economic assumptions. The committee concluded that a more accurate measure of liabilities for tax purposes can be achieved by imposing specific rules for the computation of tax reserves that result in a reserve which approximates the least conservative (smallest) reserve that would be required under the prevailing law of the States.

A fourth concern which the committee identified is a significant shifting of tax toward the mutual company segment of the industry. As interest rates rose, investment income became an increasingly large portion of life insurance company income. Many stock companies can offset at least a portion of this income with losses generated by their underwriting activities. Mutual companies, on the other hand, generally charge higher premiums for their products and are less likely to have underwriting losses. Thus, with the permanent repeal of the provisions governing modified coinsurance transactions, there may be a significant shifting of tax under the 1959 Act toward mutual companies.

New approach

The single phase tax contained in the bill was designed by reference to a stock life insurance company model. This choice was made because it provides a relatively simple tax structure for life insurance companies that bears a close resemblance to the general structure of corporate income taxation. Further, the choice of the stock company model reflected the view that life insurance is primarily a commercial activity, and that no company should engage in it without being subject to Federal income taxes.

In redesigning the statutory scheme for taxation of life insurance companies, the committee was concerned that the new provisions not unduly prejudice companies by suddenly increasing their tax liability by substantial amounts. Although the committee was concerned that deductions which do not reflect economic expenses generally are inappropriate, it nonetheless concluded that the difficulties which might result from a sudden increase in the industry's tax burden warranted an exception in this case. Thus, the committee provided special rules for smaller life insurance companies since most of these companies enjoyed substantial benefits under existing law. In addition, the committee bill provides an across-the-board rate reduction for life insurance companies which will cushion the impact of the new rules and assure their tax-related competitive position relative to other financial intermediaries, and other tax-exempt entities in direct commercial competition with life insurance companies.

Life insurance products

Life insurance policyholders traditionally have benefited from a special position under the tax Code. Under present law, policyholders benefit principally from the tax free accumulation of cash value under life insurance policies and the deductibility of interest payments for indebtedness. Cash values accumulate under any one of several premium payment systems for whole life insurance which result in larger premium payments than required to fund current insurance protection. The build-up occurs when a level premium payment plan applies to the policy, and the premium payments in the early policy years exceed the current cost of insurance computed using assumed mortality table and interest rates. In the later years of the contract, the annual cost of insurance is higher and for the nominal face amount of coverage may exceed the annual level premium payment. The cash value build up in the policy, however, reduces the actual insurance risk and therefore the cost of insurance. Under present law, the policyholder is not taxed on increases in the cash value (for example, from investment earnings) unless the contract is surrendered prior to the death of the insured for an amount in excess of the gross premiums paid. Both cash value and reserves grow as the balances earn interest, but the accruals of interest are not included in the policyholder's gross income and therefore are not subject to taxation. In addition, the growing cash value may be used as collateral for a loan from the insurance company. The policyholder may deduct the interest payments made with respect to this loan just as all interest payments on loans are deductible. In this case, however, significant portions of the principal amount (i.e., cash value) that is borrowed has accrued as untaxed interest income. Thus, an insurance policyholder may withdraw his cash value through the loan mechanism without recognizing gain and deduct his cost of avoiding the recognition of income. This combination of deferral, access to the income, and interest deductions is unique to life insurance. With respect to other forms of tax-free income, such as income from all-savers certificates (the last of which will soon mature) and bonds issued by State and local governments, borrowing on the collateral of the bond or certificates is not permissible. With respect to an individual retirement account (IRA), the deposits and interest accruals occur tax-free, but they are taxed when drawn upon in later years within statutory limits; premature withdrawals, including loans, are subject to a penalty tax and also are included in the taxpayer's gross income in the withdrawal year.

In light of the significant tax advantages associated with life insurance products, the committee undertook a review of those products and their treatment. Four areas of concern were identified as appropriate for legislation. First, in recent years, companies have begun emphasizing investment oriented products that maximize the advantages of the deferral provided in the Code. When compared to traditional products, these products offer greater initial investments or higher investment returns or both. In response the committee adopted a definition of life insurance that treats as currently taxable investments, life insurance policies that provide for much larger investments or buildups of cash value than traditional products.

A second area of concern was the treatment of annuity contracts. The committee believes that the present law treatment of annuities (deferral of tax on investment income) is justified only by the retirement savings purpose of annuities. Thus, an exception to the early withdrawal penalty for amounts earned on investments that are kept in the annuity contract for at least 10 years, was viewed as inappropriate since it permits penalty-free preretirement withdrawals. Similarly, the committee believes deferred income in an annuity should be taxed to the annuity owner during his or her lifetime. Thus, if the owner dies before annuitization, the deferred income should be included in the owner's last income tax return.

A third concern identified by the committee was the use of policyholder loans to withdraw cash values from life insurance contracts without tax on the inside buildup. To limit possible abuses of this loan feature, the committee decided to impose a high limit on the deductibility of interest on these types of loans.

Finally, the committee believes that present law limits on the amount of term life insurance coverage that can be provided to employees without inclusion of the cost of such insurance in the income of the employee should also apply to retired employees.

Nondeductible IRA contributions

The committee recognizes that an individual is permitted to make nondeductible payments to purchase a tax-deferred annuity contract and that the income earned under the contract is not taxed until amounts are paid under the contract. The committee believes that individuals should be encouraged to save for retirement by making nondeductible contributions, within limits, to IRAs. In order to provide similar tax treatment for nondeductible contributions under tax-deferred annuity contracts and nondeductible contributions to IRAs, the committee intends that amounts paid or distributed out of nondeductible contributions made to an IRA will be taxed first on the income attributable to nondeductible contributions. Finally, the committee recognizes the need for separate accounting and recordkeeping requirements with respect to nondeductible IRA contributions in order to ensure that the nondeductible contributions and the income attributable thereto retain their character when paid or distributed from the IRA or when rolled over to another IRA.

C. Explanation of Provisions

1. Overview of the Bill

General rules

Title II of the bill contains four subtitles. Subtitle A is the amendment that provides a complete substitute for the present law tax treatment of a life insurance company. (Part I of Subchapter L of the Internal Revenue Code, sections 801-819A, will be repealed and will be replaced by the amendments in subtitle A of title II of the bill.) Subtitle B provides new rules relating to the treatment of life insurance products which are in addition to those of present law. Subtitle C provides for nondeductible contributions to IRAs, and subtitle D provides for certain studies and reports to the tax committees relating to the tax burden on life insurance.

Code section 801 imposes an income tax on the taxable income of a life insurance company (which is defined in sec. 816). Taxable income is defined as life insurance company gross income less life insurance company deductions. Life insurance company gross income is defined in section 803. The deductions which are allowed to be made from gross income are set forth in section 804, and described in some detail in section 805 (the general deductions) and section 806 (the special deductions). Further specification of these deductions is provided in sections 807 and 817 (rules for reserves and variable contracts), sections 808 and 809 (policyholder dividends), and section 810 (operations loss).

Accounting provisions that relate to life insurance company taxation are contained in section 811. In section 812, the company's share and policyholders' share are defined, and the proration of various types of income between the two shares also is described. Sections 813 and 814 relate to foreign life insurance companies and contiguous country branches of domestic life insurance companies.

Subtitle B of title II contains the definition of a life insurance contract (sec. 221), the treatment of annuity contracts (sec. 222), the limitation on the interest deduction in case of life insurance loans (sec. 223), and further rules relating to group-term life insurance purchased for employees (sec. 224).

Subtitle C provides for the allowance of nondeductible contributions to IRAs, beginning in 1984, of up to $1,750 per year for each taxpayer having a tax-deferred IRA.

Subtitle D contains requirements for studies which will report upon the various aspects of the industry (e.g., revenues, segment balance, etc.). These Treasury studies are to be completed at various dates and reported to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Relationship to the 1959 Act

Although the bill amends the Internal Revenue Code by repealing the life insurance company taxation provisions of the 1959 Act and replacing them with an entire new Part I of subchapter L, the committee intends that the provisions of the new Part I which are based on present law be interpreted in a manner consistent with present law. Thus, where provisions of existing law are incorporated in the bill, the committee expects that, in the absence of contrary guidance in this report, the regulations, rulings, and case law under existing law may serve as interpretative guides to the new provisions.

2. Tax Treatment of Life Insurance Companies

a. Definition of a life insurance company (new sec. 816)

Present Law

A company is taxed as a life insurance company if (1) it is an insurance company; (2) it is engaged in the business of issuing life insurance and annuity contracts (either separately or in combination with accident and health insurance), or noncancellable accident and health insurance contracts; and (3) more than 50 percent of its total reserves are life insurance reserves or unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, accident or health policies not included in life insurance reserves.

Under present law, there is no statutory definition of an insurance company. Treasury regulations, however, provide that an insurance company is a company "whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." (Treas. Reg. sec. 1.801-3(a)).

Life insurance reserves are amounts which are (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) are set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident contracts involving (at the time the reserve is computed) life, health or accident contingencies. Also, life insurance reserves must be required by law. The term total reserves means (1) life insurance reserves, (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law. The term total reserves does not include deficiency reserves.

Explanation of Provision

The bill generally adopts the present law test for determining whether an insurance company is a life insurance company and for this purpose, continues to look to properly computed statutory reserves. However, for purposes of qualifying as a life insurance company, the bill adopts a statutory definition of an insurance company. Specifically, for purposes of qualifying as a life insurance company, a company must be one for which more than half of the business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risk underwritten by insurance companies. By requiring more than half rather than that the "primary and predominate business activity" be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies under present law. Whether more than half the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities. It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Code; see, e.g., *Service Life Insurance Co. v. United States,* 189 F. supp. 288, aff'd. on other grounds. 293 F. 2d 78 (8th Cir. 1961).

Also, because the definition of a life insurance company, under the bill, looks to the activities of the company for the entire taxable year, a company will be characterized for that year as a life insurance company or as a property and casualty company on the basis of its activities for the entire year. This definitional change from present law, however, is not intended to override any authority of Treasury to issue regulations under section 1502 relating to the filing of consolidated returns.

The bill adopts the same definition of a life insurance reserve as under present law. In doing so, the special recognition afforded noncancellable accident and health insurance contracts in the 1959 Act as being comparable to life insurance contracts because of their long-term rate commitments is continued.

In general, the bill adopts the present law definition of total reserves. However, the bill also provides that, for purposes of determining whether an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves. Thus, these amounts are not included in either the numerator or the denominator of the qualification fraction when determining whether a company's life insurance reserves and unearned premiums and unpaid losses on noncancellable accident and health insurance contracts comprise more than half its total reserves.[5] This provision resolves for future years a question under present law as to how certain pension funds that do not contain permanent life annuity purchase rate guarantees should be treated.[6] The Internal Revenue Service has ruled that a reserve for a benefit is not a life insurance reserve unless a life benefit is permanently guaranteed under the contract (Rev. Rul. 77-286, 1977-2 C.B.228). The provision under the bill substantially adopts this position and extends it to total reserves also, but only for purposes of the qualification fraction. The fact that such funds are not treated as insurance reserves for purposes of the qualification fraction is not intended to have any affect on the characterization of the contracts or of the company issuing the contracts. Rather, whether a contract with less than a permanent guarantee should be considered an insurance or annuity contract would depend on the terms of the contract. That is, it will depend on whether the company has assumed a significant insurance risk or has made an annuity guarantee (for life or a fixed period). Generally, the assumption of solely an investment risk would not give rise to an insurance liability.

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[5] If these contracts have any insurance or annuity purchase rate gaurantees (for life or a fixed term), then the premiums will be taken into income and the increase in the fund will be treated as increases in a reserve item under section 807(c)(3) or (4). If there are no guarantees whatsoever, then no income will be taken into account and no reserves will be treated as increased for purposes of the reserve deduction.

[6] The question was temporarily mooted by a TEFRA provision which prevented any company from changing its life insurance company status because of the treatment of such reserve funds.

b. Computation of life insurance company taxable income (new secs. 801, 803, 804, 805, and 806)

Present Law

A life insurance company currently is subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system a company is taxed currently on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeds its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations is accounted for as part of a policyholders' surplus account and, subject to certain limitations, is taxed only when distributed to stockholders or upon corporate dissolution (Phase III). Thus, although life insurance companies are taxed at the normal corporate rates under present law, special accounting rules are provided for computing taxable income. Consistent with the taxation of other taxpayers, net capital gain that is taxable to the company may be subject to an alternative tax.

Explanation of Provisions

Life insurance company taxable income (new sec. 801)

Under the bill, a life insurance company will be taxed at corporate rates, under a single-phase system, on its life insurance company taxable income (LICTI). LICTI is life insurance gross income reduced by life insurance deductions. As under present law, net capital gain that is taxable to the company may be subject to an alternative tax. Likewise, a stock life insurance company will be taxed, at corporate rates, on any distributions from a pre-1984 policyholders surplus account.

In general, as described below, a special life insurance company deduction and a small life insurance company deduction each result, in effect, in a lowering of the tax rates on LICTI. However, if amounts are subject to the alternative tax on capital gains, the special life insurance company and small life insurance company deductions are not allowed to reduce the amounts subject to that tax, because it already provides a lower than normal tax rate (new sec. 801).

Life insurance gross income (new sec. 803)

Under the bill, life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income. For these purposes, premiums consist of the gross amount of premiums and other consideration received on insurance and annuity contracts reduced by return premiums paid to policyholders such as on the cancellation of a policy, and premiums and other consideration paid to another insurer on indemnity reinsurance (new sec. 803).

As under present law, the premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and any policyholder dividends reimbursable by a reinsurer. Return premiums do not include amounts paid to policyholders, which are not fixed in the contract but depend on the experience of the company or the discretion of the management, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Furthermore, amounts rebated or returned due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

The use of the term "indemnity reinsurance" in the bill, instead of "reinsurance ceded" under present law, is not intended to be a substantive change from present law. Likewise, the reference to insurance and annuity contract, rather than to "insurance and annuity contracts (including contracts supplementary thereto)" is not a substantive change from present law. A general provision, applicable to the life insurance company part of the Code only, states that any reference to insurance and annuity contracts includes any contract supplementary thereto (new sec. 818(d)).

Life insurance deductions (new sec. 804)

Under the bill, life insurance deductions consist of "general" life insurance deductions (new sec. 805), the "special life insurance deduction" (new sec. 806(a)), and the "small life insurance company deduction" (new sec. 806(b)).

The general deductions (new sec. 805)

The general deductions are generally the same as the deductions allowed under present law, except that the deductions currently available to life insurance companies for nonparticipating and group life contracts and accident and health contracts are eliminated. The general deductions, under the bill are the deductions for (1) claims and benefits accrued, and losses incurred (whether or not ascertained) during the taxable year on insurance and annuity contracts, (2) net increases in reserves (see item d. below), (3) policyholder dividends (see item e. below), (4) a modified dividends-received deduction, (5) operations losses (see item f. below), (6) consideration paid for assumption reinsurance, and (7) policyholder dividend reimbursements paid to another insurance company under a reinsurance agreement. In addition, life insurance companies are allowed other deductions generally allowable to corporate taxpayers for purposes of computing taxable income, subject to certain modifications. These modifications are generally the same as under present law.

Intercorporate dividends.—With respect to the deduction for intercorporate dividends received by a life insurance company, in general the bill continues the present-law rule of prorating the deduction between the company and the policyholders as the items of investment income are allocated between the company and the policyholders. (See the discussion of new section 812 in item h. below.) However, "100 percent dividends" (i.e., dividends that would be allowed a 100 percent deduction under sections 243 or 244) are not subject to proration except to the extent they are funded with tax-exempt income or with dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. For these purposes, a distribution would be considered to be funded ratably out of tax-exempt income, dividends that would not qualify as 100 percent dividends to the taxpayer, and all other taxable income of the distributing corporation. Also for purposes of applying the exception, multi-tiered corporate ownership arrangements cannot be used to change the character of the tax-exempt interest and dividends received in an attempt to avoid proper proration.

The rationale for this special rule is that dividends received by a life insurance company parent from a subsidiary represent the earnings of the subsidiary. To the extent they are distributions of fully taxable income, these earnings have already been taxed at the subsidiary level. Including them in gross investment income would have the implicit effect of taxing these earnings a second time through operation of the proration formula. However, to the extent these earnings are distributions of tax-exempt income, they have not been taxed and should be subject to proration. Without this rule, a parent life insurance company could avoid proration of tax-exempt interest by having a subsidiary own all of its tax-exempt obligations. The subsidiary would not be taxed on this income which it could distribute to the parent as dividends. However, the proposed rule would avoid this result by having gross investment income include dividends received from a subsidiary to the extent that such dividends are distributions of tax-exempt interest or of dividend income that would not be 100 percent deductible if received directly by the taxpayer. The bill also prevents a group from using multi-tier corporations to pass dividends comprised of tax-exempt income up to a parent life insurance company.

The committee is aware that, as under present law, the proration of tax-exempt income may also be avoided by dividending surplus to a parent (nonlife insurance) company that could invest in tax-exempt income. This possibility is less troublesome than that of placing assets in a subsidiary because assets of a parent do not contribute to a company's surplus while assets of a subsidiary do. This difference effectively places a limitation on the amount of assets which a company may dividend to a parent without jeopardizing its ability to do business under State law.

Reimbursable policyholder dividends.—The specific deduction for policyholder dividend reimbursements paid by a life insurance company to another insurance company under a reinsurance agreement was originally adopted under TEFRA, as was the rule that all policyholder dividends paid by an insurance company directly insuring the policyholder are to be treated as paid by that company. The bill adopts both provisions.[7] The bill clarifies, however, that these reimbursements for policyholder dividends are expenses of the reinsuring company (the reinsurer) and are not policyholder dividends as defined for tax purposes. Also, the bill specifically uses the term "reimbursable dividends" both in referring to the deduction allowed therefor, and in referring to the inclusion of such dividends in income by the direct writer of the insurance, in order to clarify that such dividends are deductible and includible in income on an accrual accounting basis.

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[7] The committee also adopted an amendment to the TEFRA provisions, for taxable years 1981 and 1982 which is an exception to the reimbursable dividends rule. Reimbursable dividends paid pursuant to a reinsurance agreement entered into before June 30, 1955 by a life insurance company to reinsure their accident and health policies, pursuant to the direction of the National Association of Insurance Commissioners, will be treated as policyholder dividends of the reinsurer (sec. 217(h) of the bill).

The special life insurance company deduction (new sec. 806(a))

A life insurance company is allowed a deduction for any taxable year of 25 percent of its "tentative life insurance company taxable income" (tentative LICTI) over the amount of the company's small life insurance company deduction. The committee believes that although the bill provides for the proper reflection of the economic income of a life insurance company without this deduction, some adjustment is necessary to avoid suddenly imposing a substantially increased tax burden on life insurance companies. Under present law, a life insurance company is able to defer or avoid taxation on a substantial portion of its current income, and thus this provision ameliorates the hardship that might otherwise result from a sudden, substantial increase in a company's tax base and insures that life insurance companies remain competitive with other tax-favored and tax-exempt financial intermediaries (e.g., banks, thrift institutions, self-insurance trusts, Blue Cross-Blue Shield, etc.).

As indicated above, the tax base for the special life insurance company deduction is tentative LICTI. Generally, a company's tentative LICTI is its life insurance company taxable income determined without regard to (1) the special life insurance company and small life insurance company deductions, and (2) any items (income or loss) attributable to any noninsurance business.

Under this provision, the special life insurance company deduction applies only with respect to income resulting from a company's life insurance business. Thus, gains and losses arising from a noninsurance business operated by a life insurance company will neither increase nor decrease the amount of the company's special life insurance company deduction (or small life insurance company deduction). For these purposes, noninsurance business means any trade or business which is not an insurance business. Generally, insurance business refers to the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to the contracts issued or reinsured by the taxpayer. Thus, for example, if a life insurance company ran a manufacturing business directly (rather than owning stock in the company), any income and deduction items attributable to the manufacturing business would not be taken into account in computing tentative LICTI. Likewise, if a life insurance company acted as a broker, buying and selling securities directly for the public, such activities would not be investment activities that are necessary to support contractual obligations to policyholders in the insurance business, and would be noninsurance business.

The concept of noninsurance business is further modified by a provision that any business that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is to be treated as insurance business. This modification recognizes that life insurance companies have traditionally engaged in certain types of income-producing activities as investments, either directly or though partnership interests, that could be viewed as noninsurance business activities. Examples would be the ownership and rental of real estate and the development and sale of real estate. Likewise life insurance companies have traditionally offered administrative services on certain deposit contracts or contracts without any insurance guarantees. Such noninsurance business activities will be treated as insurance business for purposes of computing tentative LICTI.

The application of this rule can be illustrated as follows. If a life insurance company (not eligible for any small life insurance company deduction) has $100X of net income from its insurance business and $10X of net income from its noninsurance business, the amount of its special life insurance company deduction is $25X (i.e., 25 percent of $100X). If, instead, the company has $100X of net income from its insurance business and a $10X loss from its noninsurance business, the company's deduction still would be $25X (i.e., 25 percent of $100X). The purpose of this provision is to limit the tax rate adjustment to life insurance income and protect noninsurance businesses from unfair competition from life insurance companies that enter into noninsurance businesses.

In addition, the bill limits the amount of the special life insurance company deduction by treating all life insurance companies that are members of the same controlled group as one company whether such companies join in the filing of a consolidated return or file separate returns. The special life insurance company deduction is then allocated proportionally among the life insurance company members of such group with a positive tentative LICTI. For these purposes, the term controlled group is defined generally by reference to section 1563. In prescribing this rule, it is recognized that the gain or loss of any life insurance company member will be reflected in the computation of the affiliated group's tentative life insurance company income even if that particular member is not allowed to join in the consolidated return because it has not been a member of the affiliated group for the required time. In this situation, a loss of such a company would reduce the special life insurance company deduction even though the loss would not reduce consolidated tentative LICTI. Later, when the ineligible member can join in the consolidated return, a carryover of the earlier loss might in fact reduce such tentative LICTI, along with the group's special deduction for that year. The committee intends that Treasury shall take this potential double reduction into account under its regulations for filing consolidated returns so that the second reduction will not occur when the loss member company becomes eligible and joins in the consolidated return.

Also, a special rule applies to corporations joining in the filing of a consolidated Federal income tax return. Under this rule, no items of income or loss of nonlife members of the affiliated group joining in the return are taken into account for purposes of computing tentative LICTI.

The small life insurance company deduction (new sec. 806(b))

Under the bill, small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. This deduction also is based on tentative LICTI, and applies before the special life insurance company deduction.

The amount of the deduction is 60 percent of so much of tentative LICTI for such taxable year as does not exceed $3,000,000, reduced by 15 percent of the excess of tentative LICTI over $3,000,000. For example, if a small life insurance company has tentative LICTI of, $2,900,000, its small life insurance company deduction would be $1,740,,000 (i.e., 60 percent of $2,900,000). If the company's tentative LICTI is, $3,900,000, its small life insurance company deduction would be $1,665,000 (i.e., 60 percent of $3,000,000 reduced by 15 percent of the excess of $3,900,000 over $3,000,000). Under this provision, the maximum benefit that can be enjoyed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more would not be entitled to any small company deduction. For these purposes, the term tentative LICTI has the same meaning as it does for purposes of the special life insurance company deduction, that is, it does not include any items (income or loss) attributable to a noninsurance business.

As in the case of the special life insurance company deduction, the small life insurance company deduction is computed by treating all life insurance companies that are members of the same controlled group as one company whether those companies join in the filing of a consolidated return or file separate returns. The small life insurance company deduction is then allocated among the life insurance company members of such group in proportion to each such member's separate positive tentative LICTI.

The small life insurance company deduction is only allowable to companies with gross assets of less than $500,000,000. Except for real property and stock, which are taken into account at fair market value, the amount attributable to an asset is the adjusted Federal income tax basis of such asset for purposes of determining gain. Interests in partnerships or trusts are not treated as assets of the company. Rather, a company is treated as owning its proportionate share of the assets of any partnership or trust in which it has an interest. These rules are intended to prevent companies from holding assets in a noncorporate entity in order to qualify for the small company deduction. With some modifications, this approach for valuing assets is consistent with the valuation of assets for tax purposes under present law.

The asset qualification for the small company deduction is determined on the basis of a controlled group as defined in section 1563. The committee believes that this controlled group rule, which takes into account both insurance and noninsurance businesses, is appropriate because the small companies that require added special treatment are those that cannot look to a parent corporation or affiliate with substantial assets for capital during their growth period. Similarly, the restriction will prevent the small company deduction from creating an incentive for large noninsurance businesses to take over small independent insurers.

As in the case of the special life insurance company deduction, the committee believes that, without this provision, the bill provides for the proper reflection of taxable income. Nonetheless, the committee recognizes that small life insurance companies have enjoyed a tax-favored status for some time, and believes that it would not be appropriate to dramatically increase their tax burden at this time.

c. Policyholders surplus accounts (new sec. 815)

Present Law

As noted above, present law permits stock life insurance companies to defer the tax on 50 percent of their gain from operations in excess of their taxable investment income. The deferred income is added to a policyholders surplus account, along with amounts deducted for nonparticipating contracts and group life and accident and health insurance contracts. Amounts in the policyholders surplus account are taxed only when distributed by the company to its shareholders. To determine whether amounts have been distributed, a company must maintain a shareholders surplus account which generally includes the company's previously taxed income and certain nontaxable items that would be available for distribution to shareholders. Distributions to shareholders are treated as being first out of the shareholders surplus account, then out of the policyholders surplus account and finally out of other accounts.

Explanation of Provision

In general, the bill eliminates any further deferral with regard to income for 1984 and later years. Although companies will not be able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules comparable to those provided under the 1959 Act, but which reflect the basic changes in the tax structure under the bill.

The bill provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution. For these purposes, the term "distribution" is intended to include actual and constructive distributions. See *Union Bankers Insurance Co.,* 64 T.C. 807 (1975). Although new amounts will not be added to the policyholders surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of previously-taxed and other amounts that are eligible for distribution before a distribution is made from the policyholders surplus account. Thus, the bill provides for appropriate additions to the shareholders surplus account based on the new provisions adopted and replacing the 1959 Act.

Specifically, for each taxable year, the excess of the sum of the following amounts over the taxes paid for the year will be added to the shareholders surplus account: (1) LICTI (determined without regard to any distributions from the policyholders surplus account); (2) the special life insurance company deduction; (3) the small life insurance company deduction; (4) the deduction allowed the company for intercorporate dividends received; and (5) excluded tax-exempt interest. In developing this list of additions to the shareholders surplus account under the new provisions, additions for certain capital gains and the policyholders' share of the intercorporate dividend deduction were not included in order to prevent some of the double counting that existed under the 1959 Act. Also, the addition for the small company deduction of $25,000 under the 1959 Act was eliminated as is that deduction under the new tax structure. On the other hand, under the bill, the amount of the new special life insurance company deduction of 25 percent of tentative LICTI is added to the shareholders' surplus account, along with the new small life insurance company deduction. These new items may substantially increase annual additions to the shareholder surplus account, in comparison with present law, and thus may more than offset the modifications made to the account to eliminate double counting.

Aside from the changes indicated for maintaining the shareholders surplus account, the bill generally adopts the provisions of the 1959 Act with respect to the phase III tax. Thus, the ordering rules for distributions and subtractions, the requirement that distributions from the policyholders surplus account be "grossed up" for taxes payable thereon, and limitations on the size of the policyholders surplus account as a percentage of reserves, in general, will continue to apply. In so continuing these provisions, the committee intends that any reference to reserves be to reserves computed in a manner consistent with the provisions of the 1959 Act.

d. Deductions with respect to reserves (new secs. 807 and 817)

Present Law

A life insurance company is allowed to deduct (or exclude from income) increases in its year-end reserves over those for the prior year. Under present law, there are two elements to the deduction for reserves. First, for purposes of computing its taxable investment income, a life insurance company can exclude from its investment yield (i.e., gross investment income less investment and similar expenses) the policyholders' share of that investment yield. Second, for purposes of computing gain and loss from operations, a life insurance company can deduct increases in reserves allocable to premium income (i.e., increases in reserves, adjusted to not include required interest that is credited to its reserves and excluded in the computation of taxable investment income). A life insurance company's tax reserves are based on its reserves for State regulatory purposes (i.e., statutory reserves) and, as a general rule, a company's deduction reflects an increase in its statutory reserves over its statutory reserves for the prior year.

Under present law, life insurance reserves must be (1) required under State law, (2) computed or estimated on the basis of recognized mortality or morbidity tables and an assumed rate of interest, and (3) set aside to mature or liquidate future claims under life, annuity, or noncancellable accident and health insurance contracts.

Statutory reserves are calculated under a preliminary term method or the net level premium method. Generally, under a preliminary term method, first year expenses (e.g., commissions) are funded out of the premiums for the first year, and only the excess of net premiums reduced by such expenses is available to fund reserves. Under the net level method, the first year expenses are treated as funded out of net premiums over the life of the contract. Companies using this method for State regulatory purposes have larger reserves in the early years of a contract than companies using the preliminary term method. However, because expenses not funded out of premiums must be funded out of surplus, the net level method is, for all practical purposes, not generally available to companies with limited amounts of surplus.

A life insurance company is allowed to revalue its preliminary term reserves for tax purposes to eliminate a disparity that would otherwise result in the tax treatment of life insurance companies with greater amounts of surplus and companies with smaller surplus accounts. Reserves computed for statutory purposes on a preliminary term basis may be revalued to a net level premium basis using either an exact revaluation method or an approximate revaluation. Reserves recomputed under the approximate formula (as modified by TEFRA) are revalued by increasing such reserves by (1) $19 per $1,000 of insurance in force for other than term insurance, less 1.9 percent of the reserves under such contracts, and by (2) $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula may result in greater reserves than actual net level premium reserves or reserves recomputed using an exact revaluation method.

Under present law, a special rule provides for the treatment of income or loss resulting from a change in the method of computing reserves. Under the rule, if as of the close of any taxable year the basis for determining the amount of any increase or decrease in reserves differs from the basis for such determination as of the close of the preceeding taxable year, any resulting income or loss is taken into account ratably over a 10-year period.

In addition to the rules described above which apply to life insurance contracts, other rules provide for unearned premium and unpaid loss reserves for accident and health insurance contracts. Under these rules, unpaid losses may be estimated and reserved for on a nondiscounted basis. For purposes of determining the amount of the deduction for the addition to the unearned premium reserve, gross premiums are considered to be earned pro rata over the life of the contract.

Explanation of Provisions

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. Unlike under the 1959 Act, the deduction for increases in reserves would take into account increases due to both premiums and assumed interest credited to the reserves. In general, the net increase or net decrease in reserves, is computed by comparing the closing balance for reserves to the opening balance of the reserves, where the closing balance of the reserve becomes the opening balance for the following year.

Also, in computing the net increase or net decrease in reserves, the closing balance of the reserve items is reduced by the policyholders' share of tax-exempt interest. This continues the view under present law that a life insurance company's reserve liability to its policyholders in effect entitles the policyholders to a pro rata portion of each item of investment income.

Reserves taken into account

In computing the net increase or net decrease in reserves, the bill specifies that six items, which are all reserves or in the nature of reserves, be taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations which are obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts;[8] (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are held for retired lives, premium stabilization, or a combination of both.

The six items specified in the bill generally are the same items as under present law. However, the bill requires that the amount of the contingency reserves held for retired lives and premium stabilization be reasonable in relation to the amount of coverage provided by, and the loss experience suffered by, the company with respect to the underlying group contract. Also, the bill requires that the discount rate used by the companies for a reserve amount for an insurance and annuity obligation that does not involve life, accident, or health contingencies be the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits. These rates are to be determined when the obligation first ceases to involve life, accident, or health contingencies.

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in present law required proper computation under State law in order for deductions to be allowed, because present law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The bill, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves.

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[8] The investment portion of any life insurance contract which fails to meet the definition of a life insurance contract under section 7702 is treated as a reserve under section 807(c)(4)

Computation of reserves

For purposes of determining life insurance company taxable income, the bill provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. In no event will the amount of the tax reserves at any time exceed the amount of the statutory reserves. The net surrender value is the cash surrender value reduced by any surrender penalty except that any market value adjustment required on surrender is not taken into account. Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on a aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualifying supplemental benefit or qualifying substandard risk (see discussion below on special rules).

The bill requires that, in computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used, along with the prevailing State assumed interest rate and the prevailing commissioners' standard tables for mortality or morbidity. The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more unless the net surrender value is greater. To avoid State-by-State variations, the rules prescribed in the bill are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.

Reserve method

With respect to the reserve method to be used, the bill prescribes specific tax reserve methods for particular types of contracts. For life insurance contracts, the prescribed method is the applicable Commissioners' Reserve Valuation Method (CRVM) in effect when the contract is issued. This is the date that appears on the policy form. For annuity contracts, the prescribed method is the applicable Commissioners' Annuities Reserve Valuation Method in effect when the contract is issued.[9] For noncancellable accident and health insurance contracts a 2-year full preliminary term method is required. Finally, for all other contracts, the reserve method prescribed by the NAIC or, if no method is so prescribed, a method consistent with whichever of the prescribed methods that would be most appropriate for the contract. An example of a life insurance contract not presently covered by an NAIC prescribed method is a universal life insurance contract. Until NAIC prescribes an appropriate method for universal life insurance, reserves should be computed on a method consistent with CRVM. Also, the committee understands that the NAIC has not prescribed a method for contracts issued by assessment companies in Texas (i.e., either mutual assessment companies or stipulated premium companies), because such life insurance companies generally are not found outside of Texas. Under Texas law, reserves for such policies are computed on a half-year full preliminary term method and such method should be considered to be consistent with CRVM's prescribed by the NAIC.[10]

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[9] There is a special rule for a company domiciled in a State which, in determining minimum reserves for an annuity contract for State purposes, does not reduce the reserves for surrender charges. Section 217(c) of the bill provides that if a State has continuously pursued this practice since September 27, 1983, then any life insurance company domiciled in that State may adjust its Federally prescribed reserves (under section 807(d)(2)) by taking into account the reasonable surrender charges.

Interest rates and mortality tables

With respect to the assumed interest rate and the mortality or morbidity tables to be used in computing the Federally prescribed reserve, the bill looks to the "prevailing view" of the States. A view is considered to be a prevailing view if it is recognized by at least 26 States when the contract is issued. Thus, the "prevailing State assumed interest rate" means, for any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued in at least 26 States. For nonannuity contracts, the issuing company may elect, on a contract by contract basis, to use the prevailing interest rate from the preceding calendar year. In determining the highest assumed rates permitted in at least 26 States, each State should be treated as permitting the use of every rate below its highest rate. Also, the highest State assumed interest rate referred to in the bill is the highest permitted to be used in computing reserves without taking into account any limitations that might be imposed by States if a different rate is assumed for computing cash surrender values under Standard Nonforfeiture laws.

Like the prescribed interest rate, the prevailing commissioners' standard tables for mortality or morbidity to be used for computing the Federally prescribed reserves are, with respect to any contract, the most recent tables prescribed by the NAIC and permitted to be used for that type of contract in computing reserves under the laws of at least 26 States when the contract is issued. Generally, when mortality and morbidity tables are being updated and adopted by the States, companies will have three full years after a particular set of tables becomes the prevailing view of the States before such table become mandatory for computing reserves for tax purposes. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because of poor health or because the insureds reside in a foreign country known to be experiencing civil strife.

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[10] An exception from the general mortality and morbidity tables requirements for reserves for life insurance contracts issued by assessment companies is also provided as a noncode amendment. These companies may use the table used for State law purposes if that mortality and morbidity table was developed by taking into account the particular experience of those companies and was in existence and in use by 1965. Further revisions of such unique tables would be allowed for tax purposes only if the table is revised in a manner consistent with the way in which the original table was developed. Finally, there is a noncode amendment that allows mutual assessment companies in Texas to use their statutory reserves for tax purposes. (sec. 217(g) of the bill).

The bill also provides special rules for existing contracts where standard tables are not available. For example, in recomputing all reserves for tax purposes as of January 1, 1984, the reserves for contracts issued before 1948 (when the use of commissioners' standard tables was first required), can be computed based on the mortality or morbidity tables used for State law purposes.

Change in computing reserves

The present law rule allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained under the bill.

Special rules

In addition to the above described rules for computing the Federally prescribed reserves, the bill provides some special rules for life insurance reserves under pension plan contracts, group contracts, certain supplementary benefit provisions, substandard risks, and contracts issued by foreign branches of domestic life insurance companies.

Pension plan and group contracts

For purposes of computing the amount of life insurance reserves for pension plan contracts, the net surrender value of a contract is deemed to be an amount equal to the balance in the policyholder's fund (determined without regard to any market value adjustment). The term "policyholder's fund" refers generally to any experience fund, experience accumulation or asset share allocable to the contract.

For purposes of computing the Federally prescribed reserve for any group contract, the date the contract is issued is generally the date as of which the master plan is issued. However, if a benefit is guaranteed to a plan participant after such date, the company must take into account the date as of which the benefit is guaranteed in computing its reserves.

Supplemental benefits

Under the bill, the amount of the life insurance reserve for certain enumerated supplemental benefits is the statutory reserve. The committee believes that, due to the de minimis nature of the enumerated supplemental benefit reserves, economic distortions caused by using statutory reserves would be minimal. The supplemental benefits listed are any (1) guaranteed insurability benefit,[11] (2) accidental death or disability benefit, (3) convertibility benefit, (4) disability waiver benefit, or (5) any other benefit prescribed by regulations, if such benefit is supplemental to a contract for which there is a policyholder reserve item taken into account for taxable income purposes. The reserve for any other benefit provided for under the contract and not listed above, whether or not such a benefit is considered supplemental under State law, must be computed using the Federally prescribed method (as described in section 807(d)).

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[11] Because of the intended de minimis nature of the listed supplemental benefits, a disabled lives reserve under a disabilty income benefit provision is not intended to be contrued as a supplemental benefit.

If a supplemental benefit is a "qualified supplemental benefit", the life insurance reserve for such benefit shall be computed separately as though such benefit were under a separate contract. A qualified supplemental benefit is a supplemental benefit as listed in the bill, if there is a separately identified premium or charge for such benefit and any cash value (i.e., net surrender value) under the contract attributable to any other benefit is not available to fund such supplemental benefit. The use of any loan provision to pay premiums or charges due for the supplemental benefit is not intended to be construed as making any net surrender value available for the purposes of this provision.

For example, if a contract provides for a qualified supplemental benefit (e.g., accidental death or disability) and the net surrender value of the contract is $4,000 and the reserves are $3,800 for the basic death benefit and $50 for the supplemental benefit, the total reserve for tax purposes will be $4,050 if none of the net surrender value is attributable to the qualified supplemental benefit. In essence, the supplemental benefit is considered a separate contract and the reserve is computed as the greater of the net surrender value or the tax reserve. If however the supplemental benefit was not a qualified supplemental benefit, the total reserve for tax purposes would be $4,000 because the supplemental benefit would not be considered a separate contract and the amount of the life insurance reserve for the contract is the greater of the net surrender value (i.e., $4,000) or the Federally prescribed reserves amount (i.e., $3,800 + $50).

Substandard risks

The amount of life insurance reserve for any "qualified substandard risk" will be computed as if under a separate contract. A substandard risk is a qualified substandard risk if (1) the insurance company maintains a separate reserve for such risk, (2) there is a separately identified premium charge for such risk, (3) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and (4) the net surrender value under the contract may not be used to systematically pay premium charges for such risk. For example, the committee expects that regulations could provide that a provision for the systematic borrowing based on the net surrender value of the contract to pay both the basic premium and the substandard charge will be considered to disqualify the substandard risk in certain situations. However, loan provisions that are not regular and automatic do not constitute a systematic funding of premiums for substandard risks.

The amount of the life insurance reserve determined for any qualified substandard risk will in no event exceed the sum of the separately identified premium charges for such risk less mortality charges. The aggregate amount of insurance in force under contracts to which these special rules for substandard risks can apply cannot exceed 10 percent of insurance in force (other than term insurance) under life insurance contracts of the company. Also, if a company computes a separate substandard reserve under this provision, the mortality assumption for purposes of computing the reserve for the basic benefit cannot take into account any substandard risk factors.

Reserves under foreign law

There is a special rule which allows domestic life insurance companies to recognize, in lieu of the Federally prescribed reserve, the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of a noncontiguous foreign country if (1) the reserves arise out of life, accident or health insurance contracts issued to residents of the foreign country and (2) the foreign country requires the domestic company (as of the time it began operations in the foreign country) to operate in such country through a branch. The reserve cannot exceed the net level reserve for a contract as determined using NAIC standards and the interest rates and mortality tables used in the contract.

Variable contracts (new sec. 817)

The bill continues to provide the special rules as under present law for variable annuities and contracts with reserves based on segregated asset accounts and extends those rules to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in value of assets or by adding any amount attributable to depreciation. Such adjustments for appreciation or depreciation are to be made whether or not the company has disposed of the assets during the taxable year. This adjustment in computing the annual increase or decrease in reserves for variable contracts results in the capital gain or loss being recognized and taxed at both the company level and the policyholder level, since no adjustment is made in either the company's basis or the policyholder's investment in the contract. The committee believes this current capital gains tax should be retained in order to equalize tax treatment of insurance products based on investment funds and direct investment in such funds. In the case of "pension plan contracts" (i.e., contracts that are issued as part of a qualified pension plan) the company's basis in the assets underlying such contracts is adjusted for appreciation or depreciation to the extent the reserves are adjusted. Thus, in these cases the corporate level capital gains tax is eliminated. The definition of pension plan contracts is the same under the bill as under present law except that of the phrase "purchased under contracts" was eliminated since it was considered unnecessary.

e. Policyholder dividends (new secs. 808 and 809)

Present Law

In general, under present law, policyholder dividends are dividends and similar distributions to policyholders. Interest paid and return premiums are not policyholder dividends. This statutory language has been expanded in regulations so that the term policyholder dividends generally refers to amounts returned to policyholders that are not fixed in the contract and depend on the experience of the company or the discretion of management. However, taxpayers have taken the position that the term does not include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for purposes of computing the company's reserve deduction) even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of management.

Under present law, policyholder dividends paid by mutual and stock life insurance companies are deductible at the company level. Special rules apply, however, to limit the amount of this deduction. Under the permanent provisions of the 1959 Act the deduction for policyholder dividends (and certain other special deductions) is limited to the excess of gain from operations over the taxpayer's taxable investment income plus a statutory amount of $250,000. Under temporary provisions added to the Code in TEFRA and applicable in 1982 and 1983, the deduction is limited to either (1) an amount computed under the 1959 Act rule with the $250,000 statutory amount increased to $1 million, phasing down to zero as the sum of the company's policyholder dividends and other special deductions increases from more than $4 million to $8 million, or (2) an amount equal to the statutory amount (as modified), plus 100-percent of dividends on pension business, plus 77½ percent of nonpension policyholder dividends for mutual companies (85 percent for stocks). Under present law, policyholder dividends are accounted for on a reserve basis, and a company is allowed to deduct additions to its policyholder dividend reserves for dividends that are payable during the year following the taxable year.

Explanation of Provisions

As under present law, the bill allows a deduction for dividends or similar distributions to policyholders. The bill departs from present law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of the increases in the reserves for policyholder dividends that are payable during the year following the taxable year. Under the fresh start transitional rule, this change from a reserve to an accrual method is not to be treated as a change in a method of accounting and no income or loss is to be recognized with respect to amounts in existing policyholder dividend reserves.

Policyholder dividends defined

The bill adopts a broad definition of the term policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Thus, in addition to any amount paid or credited to policyholders (including an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds. Thus, the bill corrects a possible deficiency of present law which may permit companies to avoid the limitations on policyholder dividends through the use of excess interest and experience-rated refund products rather than traditional dividend paying products.

The term excess interest means any amount in the nature of interest that is paid or credited to a policyholder and determined at a rate in excess of the prevailing State assumed interest rate for the contract (i.e., the rate used under the bill for purposes of determining the amount of the company's Federally prescribed reserve under the rules contained in new section 807(d)). Amounts in the nature of interest include all amounts paid for the use of money regardless of the particular designation adopted by the payor or payee. Thus, amounts in the nature of interest include interest payments with respect to amounts left on deposit and amounts paid in lieu of interest such as in the case of origination or service fees. Similarly, amounts in the nature of interest include amounts calculated as interest such as the increase in reserves attributable to assumed or guaranteed interest rates rather than premium contributions.Thus, for example, any increase in the cash surrender value of a contract above that which would result if the prevailing State assumed interest rate were used to compute the increase is treated as excess interest. The term premium adjustment means any reduction in the premium under an insurance or annuity contract which, but for such reduction, would have been required to be paid under the contract. If no premium amount is fixed in the contract, variations in premiums paid during the course of the contract are not considered premium adjustments. Further, a change in the amount of a premium that is attributable to the insurability of the insured is not considered a premium adjustment. Finally, the term experience-rated refunds means any refund or credit based on the experience of the contract or group involved. Thus, for example, if a company sells a group policy to an employer covering the lives of its employees and the premiums received exceed the sum of the claims paid and other expenses, any refund of such excess is an experience-rated refund. The bill also adopts the general rule that any policyholder dividend that increases any of the benefits payable under the contract (including the cash value), or reduces the premium otherwise required, is treated as paid to the policyholder and returned by the policyholder to the company as a premium.

Reduction of certain deductions of mutuals (new sec. 809)

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, the amount of the deduction for mutual companies is reduced by an amount referred to in the bill as the "differential earnings amount." If the differential earnings amount exceeds the allowable deduction, then such excess will reduce the closing balance of the company's reserves. This reduction reflects the committee's recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners.

Because mutual companies' policyholders are also the owners of the enterprise, policyholder dividends paid to them are distributions from the company that are a combination of price rebates, policyholder benefits and returns of company profits. Although there is no precise way to segregate a policyholder dividend or other payment into these various components, the committee believes that it is valid to conclude that profit oriented enterprises tend to distribute earnings to their owners in amounts that are proportional to the owners' equity in the business. Thus, the committee believes that the portion of a policyholder dividend that is a distribution of earnings can be measured as a percentage of the mutual company's equity (the "average equity base"). To determine the appropriate percentage of the equity base, the after dividend rates of return on equity for both stock and mutual companies were examined, and it was determined that the average pre-tax return on equity of mutual companies falls below that for a comparable group of stock companies. The committee believes that this difference is attributable to distribution by mutual companies of earnings to their owners.

Under the bill, this theoretical approach to identifying ownership distributions by a mutual company is given effect by means of a reduction in the policyholder dividends deduction by a "differential earnings amount". This amount is computed by multiplying the company's average equity base for the taxable year by the "differential earnings rate" for the taxable year. The differential earnings rate is the excess of the "imputed earnings rate" over the "average mutual earnings rate". As explained below, the "imputed earnings rate" is set in the Code (and subsequently adjusted) to provide comparable treatment for stock and mutual companies.

Imputed earnings rate

The imputed earnings rate for 1984 is 16.5 percent. For taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the three years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983).

The committee anticipates that this 16.5-percent rate will result for 1984 in the mutual segment of the industry bearing 55 percent of the aggregate industry tax burden. The committee believes that this is appropriate in the light of a number of factors including the historic allocation of the industry's tax burden, the relative percentages of assets held by the stock and mutual segments of the industry and the difference in treatment of mutual company policyholders and stock company shareholders.[12] Since the committee believes that the 16.5-percent rate results in an appropriate allocation of the industry's tax burden for 1984, it has decided to adjust this rate in proportion to changes in the rate of return for large stock companies and not simply to replace the imputed rate with one equal to the actual rate of return of a group of stock companies in subsequent years.

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[12] Earning that are distributed by a stock company to its shareholders are included in income by the shareholders. In contrast, in the case of a mutual company, earnings that are distrubted are not included in income by the policyholders.

The rate of return for any stock company is to be determined by the Secretary by reference to a company's statement gain from operations as a percentage of its equity base. In calculating this rate, the Secretary is to take into account companies that may be operating at a loss and, in effect, have a negative rate of return, as well as companies that are operating on a profitable basis. Further, the authority granted the Secretary to determine the rate of return includes authority to disregard or recharacterize a transaction determined by the Secretary to have been engaged in principally to manipulate the imputed earnings rate. For example, if a noninsurance parent company with a life insurance subsidiary makes a substantial capital contribution to its life insurance subsidiary during the taxable year (but such amount is not reflected in the assets at the beginning or end of the year), the Secretary would compute the rate of return for the subsidiary without taking into account the amount contributed by the parent or the income generated by such amount if the Secretary determined that the contribution was principally intended to enable the life insurance subsidiary to manipulate its rate of return. In making this determination, the Secretary would consider such factors as the existence of any nontax business purpose for the transaction and the reasonable needs of the subsidiary for capital.

A numerical average of stock earings rates is used in order to reduce the potential impact of any manipulation of the rate by a few large stock companies. The three-year period is used to preclude the possibility of sharp rises or declines in the rate of return for the stock segment of the industry, giving the mutual companies some ability to plan for and predict tax costs for purposes of marketing their products. The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets. For purposes of ascertaining the top 50 companies and their earnings rates, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies (i.e., affiliated groups will be treated as one company).

Average mutual earnings rate

The average mutual earnings rate for any year would be the weighted average of the rates of return for mutual companies. The use of an aggregate or weighted average approach is intended to prevent manipulation by large mutual companies through payment of overly large amounts of policyholder dividends which would substantially increase the differential earnings rate and adjustment in the following year.

Average equity base

The average equity base of a stock or mutual company is the average of (1) the equity base determined as of the close of the taxable year, and (2) the equity base determined as of the close of the preceding taxable year. For purposes of computing a company's average equity base for a taxable year beginning in 1984, the equity base for 1983 will be computed under the rules contained in the bill as if the bill were in effect for such year. The term equity base means an amount equal to the surplus and capital plus any nonadmitted financial assets, the excess of statutory policy reserves over tax reserves, the amount of any mandatory securities valuation reserve, the amount of any deficiency reserve or any voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other liability) payable in the following taxable year. The term nonadmitted financial asset does not include due and accrued investment income reported as a nonadmitted asset, investments in office furnishings or fixtures, or agents' balances owed to the company. Thus, for example, an amount of due and accrued interest on defaulted bonds is not a nonadmitted financial asset, even though the underlying defaulted bond may be a nonadmitted financial asset. Also, amounts included in equity under the bill would generally refer to and be valued as amounts shown on the annual statement of the company. However, a classification or characterization of an item on a company's annual statement in an attempt to avoid the requirements of the bill is to be disregarded. Thus, for example, if a company sets up a provision on its annual statement for excess interest that it will distribute in the year following the taxable year, and this provision is separate from its provision for policyholder dividends and is not adjusted for in restating annual statement reserves to tax reserves, the provision will be treated as an "other liability" payable in the following taxable year, requiring that 50 percent of such amount be included in the equity base.

As stated above, a company's average equity base is the average of its equity base determined as of the close of the taxable year and its equity base determined as of the close of the preceding taxable year.

Differential earnings rate

The differential earnings rate for any taxable year is based on a comparison of the adjusted imputed earnings rate and the average mutual earnings rate for the second preceding year. This rule is necessary because, for any taxable year, the Secretary will not have the data required to determine the average mutual earnings rate prior to the date a mutual company will file its Federal income tax return. However, when actual data becomes available, any difference between the average differential earnings amount for the taxable year and the average differential earnings amount for the second preceding taxable year is to be taken into account as an addition to or deduction from income (before computation of the special life insurance deduction and the small life insurance deduction) for the taxable year during which the Secretary determines the average mutual earnings rate for the prior taxable year. Because any additions to or deduction from income will be taken into account in the first year during which the actual average differential earnings rate can be recomputed, no interest payments are required. If a company ceases to be a mutual insurance company in any year, then any adjustment will have to be taken into account for the taxable year giving rise to the adjustment.

Special rules

The bill also contains some special rules or modifications. First, the equity base of any mutual life insurance company can be reduced by that portion of the equity base attributable to the life insurance business that is properly allocable to reserves or liabilities for life insurance contracts issued on the life of residents of Western Hemisphere countries that are noncontiguous to the United States. The equity that is properly allocable to such contracts is the same proportion as the reserves for such contracts bears to the total tax reserves on life insurance contracts (if that proportion is at least 1 to 20). This special equity base modification recognizes that a company may need to maintain higher levels of surplus because of the special classification or substandard nature of certain insureds living in foreign countries undergoing civil strife.

Finally, certain modifications to the equity base are required if a mutual life insurance company owns one or more subsidiary life insurance companies. Such subsidiaries are generally treated as stock life insurance companies in computing such subsidiaries' entity level income tax liability. However, for purposes of computing the differential earnings amount, a mutual parent of a subsidiary life insurance company must include the equity of such company in its own equity base (in lieu of the stock of the subsidiary). At the same time, for purposes of determining the statement gain from operations of the mutual parent, the mutual parent would ignore any dividends it received from the subsidiary. Also, for purposes of computing the average mutual earnings rate and the imputed earnings rate, life insurance subsidiaries of a mutual life insurance company would be counted as mutual companies. If a subsidiary life insurance company is owned by more than one mutual entity and is not a member of an affiliated group, the Secretary is given regulatory authority to prescribe how proper adjustments should be made in the equity bases of mutual life insurance companies owning stock therein to carry out the general rules described above.

f. Operations loss deduction (new sec. 810)

Present Law

Operations losses may be carried back to each of the 3 taxable years preceding the loss year and may be carried over to each of the 15 taxable years following the loss year. For a life insurance company that qualifies as a new company in the loss year, the 3-year carryback may be added, instead, to the 15-year carryover. For an operations loss incurred in a taxable year ending before December 31, 1975, the carryover period is 5 years.

Explanation of Provision

The operations loss deduction provided in the bill is substantively the same as that in section 812 in present law and new section 810 is treated as a continuation of present law section 812. Modifications are made that will conform the definition of an operations loss deduction to the new method for determining life insurance company taxable income. In both the bill and present law section

812, the operations loss deduction is consistent with the general treatment for a net operating loss in section 172.

The operations loss deduction for any taxable year is defined as the excess of life insurance deductions (which are described in section 804, above) over life insurance gross income (which is defined in section 803, above). The loss from operations for any taxable year may be carried back 3 taxable years and carried over 15 years, just as under present law. The 18-year carryover for a new life insurance company, as well as the definition of a new life insurance company, are unchanged from present law. Other rules, relating to the amount of carrybacks and carryovers and the election for operations loss carrybacks, also remain unchanged from present law.

No change has been made in the modifications to the computation of the loss from operations, which modifications exclude the carrybacks and carryovers of the operations loss deduction from the computation of life insurance taxable income and also relate to the limitation on the aggregate amount of dividends received deduction.

The operation of new section 810 may be illustrated by the following example. Assume that company A has the following results for 1984, 1985, and 1986:

	1984	1985	1986
Tentative LICTI	100,000	200,000	200,000
Small company deduction (sec. 806(b))	(60,000)	(120,000)	(120,000)
Special life company deduction (sec. 806(a))	(10,000)	(20,000)	(20,000)
Taxable income	30,000	60,000	60,000

Assume further that for 1987 and 1988, company A had losses from operations of $150,000 and $200,000, respectively. Under new section 810, the results will be as follows:

	1984	1985	1986
Taxable income	30,000	60,000	60,000
Small company deduction	60,000	120,000	120,000
Special life company deduction	10,000	20,000	20,000
Offset amount	100,000	200,000	200,000
1987 carryback	(100,000)	(50,000)	
1988 carryback		(150,000)	(50,000)
Taxable income after carryback	0	0	150,000

Thus, in 1986, the life insurance company taxable income for purposes of the small company deduction and the special life insurance company deduction is $150,000 after carryback of the net operating loss.

g. Accounting provisions (new sec. 811)

Present Law

Generally, under present law, all computations entering into the determination of life insurance company taxable income are to be made under an accrual method of accounting or, to the extent permitted under regulations, under a combination of an accrual method with any other recognized method other than the cash receipts and disbursements method. Except as provided in the general rule, all such computations are to be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners. This provision has been interpreted to mean the State regulatory accounting procedures should control so long as they are not inconsistent with accrual accounting rules (*Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148 (1977)). Also, the accounting provisions include a general prohibition against deducting an item more than once in computing taxable income.[13]

Where two or more related parties (within the meaning of sec. 1239) are parties to a reinsurance agreement, present law gives the Secretary authority to allocate or recharacterize any items necessary to reflect the proper source and character of the taxable income of each related party.

Also, there is a temporary rule (adopted under TEFRA) for computing reserves on contracts where interest is guaranteed beyond the end of the taxable year; any interest which is computed at a rate which is in excess of the lowest rate assumed in the contract and is guaranteed beyond the end of the taxable year is taken into account in computing reserves as if such interest were guaranteed only up to the end of the taxable year.

Finally, under present law there are specific rules for the amortization of premium and accrual of discount on bonds and for life insurance companies with short taxable years.

Explanation of Provision

The bill retains the general rule in present law that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, the bill makes it clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. The change from present law was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been historically allowed (even though they arguably might be classified as acquisition expenses to be amortized).

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[13] Actually, the prohibition is against deducting an item more than once in computing each subpart of taxable income—taxable investment income and gain or loss from operations.

Although the bill continues to provide a general prohibition against any double deduction of an item, it also adopts a new rule that disallows a reserve for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in gross income. Thus, because deferred and uncollected premiums for a contract do not accrue until paid, the contractual liability related to those premiums may not be recognized until the premiums are taken into income. This provision of the bill, in effect, reverses the holding of the Supreme Court in *Commissioner v. Standard Life and Accident Insurance Co.*, 433 U.S. 148 (1977), by statutorily requiring a matching of the reserve deduction with the related income item.

In the case of reinsurance agreements, the bill expands the reallocation authority granted Treasury. As under present law, in the case of a reinsurance agreement between two or more related persons, the Treasury can allocate among the parties and recharacterize income, deductions, assets, reserves, credits, and any other items related to the reinsurance agreement in order to reflect the proper source and character of the items for each party. Under the bill, however, related parties are defined as they are in section 482. Thus, two or more parties are related if they are organizations or entities, whether or not incorporated or affiliated, owned or controlled directly or indirectly by the same interests. Also, Treasury can use this new reallocation authority for a reinsurance agreement where one of the parties to the agreement, in effect, is an agent of, or conduit for, another party to such agreement. The committee believes that whether a party is an agent of, or conduit for, another party must be determined in light of all the facts and circumstances. An example of a fact that would tend to establish that an agency relationship existed is control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured. Although Treasury's reallocation authority was expanded beyond that provided in TEFRA, the new authority is prospective only and does not apply to any contract issued before September 27, 1983, which is reinsured before such date under a reinsurance agreement entered into before such date. For purposes of determining when a contract is issued, any modifications of existing contracts to expand coverage of the contracts or renewals would be treated as new contracts.

Finally, the bill includes, as a permanent provision, the accounting rule adopted as a temporary provision in TEFRA for computing reserves for contracts that guarantee excess interest beyond the end of the taxable year. Under the bill, the provision is modified to reflect the new Federally prescribed reserve rules. Thus, any amount in the nature of interest that is credited under any contract for any period at a rate in excess of the prevailing State assumed interest rate for the contract for such period and is guaranteed beyond the end of the taxable year can only be taken into account in computing reserves as if it were guaranteed to the end of the taxable year. Under this rule, "amounts in the nature of interest" include both implicit and explicit guarantees for determining contractual benefits. Thus, "amounts in the nature of interest" refers to amounts credited to policyholder reserves as assumed interest or as interest paid on such items.

With respect to the special rules for amortization of premium and accrual of discount on bonds, and short taxable years for life insurance companies, the bill makes no change from present law.

h. Definition of company's share and policyholders' share (new sec. 812)

Present Law

Under present law, all items of investment yield (i.e., gross investment income, including tax-exempt interest and dividends received, less certain investment expenses) are allocated between the policyholders and the company. Amounts allocated to policyholders are not included in taxable investment income or gain from operations. Generally, this allocation is accomplished by means of a proration formula which, in general, compares amounts credited to policyholders to investment yield. The practical effect of the proration formula is to treat additions to reserves as funded in part out of tax-exempt income thus limiting the tax benefit a company can enjoy by the receipt of tax-exempt income.[14]

The proration formula is different depending upon whether taxable investment income or gain from operations is being computed. For purposes of computing taxable investment income, each item of investment yield is allocated between the policyholders and the company in the same proportion that the sum of the company's policy and other contract liabilities bears to its total investment yield. These policy and contract liabilities are (1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate (Menge formula), (2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earning's rate, and (3) interest paid, including interest paid on indebtedness to persons other than customers.

For purposes of computing gain from operations, each item of investment yield is allocated between the policyholders and the company in the same proportion as the required interest bears to the investment yield. Required interest is the amount of interest guaranteed to the policyholders using the interest rate assumed by the company for purposes of calculating the adjustments to its section 810(c) reserves, as well as excess interest on annuity contracts.

Explanation of Provision

Under the bill, the distinction between taxable investment income and gain from operations has been eliminated. However, the general concept that items of investment yield should be allocated between policyholders and the company has been retained. Under the bill, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under present law in computing gain or loss from operations. Thus, amounts credited to policyholders will no longer include interest paid on indebtedness if the interest is paid to a person who is not a customer. For example, interest paid on a loan that is incurred to purchase a subsidiary company or other asset will not be included in determining the policyholders' share of investment yield items. On the other hand, the bill expands the items to be taken into account for the policyholders' share by including all amounts that may be paid or credited to policyholders as customers, including policyholder dividends.

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[14] "Tax-exempt income" refers generally to tax-exempt interest and deductible intercorporate dividends.

Specifically, under the bill the policyholders' share of any item is 100 percent of such item reduced by the company's share of such item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. The company's share of net investment income is the excess of net investment income over the sum of (1) the deductible portion of policyholder dividends and (2) all amounts in the nature of interest paid or credited to policyholders as customers pursuant to insurance or annuity contracts (including all pension plan contracts). Thus, the company's share is the amount of net investment income that remains after paying or crediting amounts to policyholders.

Under the bill, net investment income is defined as the excess of gross investment income over investment expenses. Gross investment income is generally the same as under present law, and includes tax-exempt interest. However, gross investment income does not include dividends received from a subsidiary which are eligible for the 100 percent dividends received deduction except to the extent such dividends are paid, directly or indirectly, out of tax-exempt income. Investment expenses are defined as the sum of the direct investment expenses plus an allocable share of the general expenses. General expenses of the life insurance company must be allocated to gross investment income in the same proportion as gross investment income for the taxable year bears to the gross receipts for the taxable year. For purposes of this formula, general expenses are indirect expenses not directly allocable to investment income or underwriting income. For example, the cost of office space housing employees engaged in both underwriting and investment activities would be allocated under this provision while office space housing employees engaged in only investment activities would be treated as a direct investment expense.

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends. 100 percent deductible dividends from affiliates are excluded from application of the proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be 100 percent deductible if received directly by the taxpayer.

i. Foreign tax credit (new sec. 818(f))

Present Law

Life insurance companies are generally subject to the same rules governing foreign income as other U.S. corporations. The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid or accrued to a foreign country ("foreign tax credit").

A credit is available only for foreign taxes that are income taxes under U.S. concepts and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government. Certain taxes on gross premiums of U.S. taxpayers engaged in the life insurance business in a foreign country have been held to be creditable "in lieu of" taxes (Rev. Rul. 74-311, 1974-2 C.B. 211; Rev. Rul. 72-84, 1972-1 C.B. 216). Income taxes paid by foreign subsidiaries of U.S. corporations are creditable when the U.S. corporation receives a dividend or a deemed dividend from the foreign subsidiary.

The foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. Under this limitation, the total pre-credit U.S. tax is multiplied by the ratio of foreign source taxable income to total worldwide taxable income to establish the amount of U.S. taxes that would be paid on the foreign income in the absence of a foreign tax credit. This amount is the upper limit on the foreign tax credit.

To calculate U.S. taxable income and foreign taxable income, which is necessary to compute the limitation, all deductions must be allocated against gross income, and apportioned against gross U.S. income or gross foreign income. Expenses that are properly allocated or apportioned to a class of U.S. (or foreign) source income reduce gross income in that category (sec. 861(b), 862(b), and 863; Reg. sec. 1.861-8). Expenses that cannot definitely be allocated to a class of gross income are generally deducted ratably from all classes of gross income.

The Internal Revenue Service has taken the position in a private letter ruling (applicable to pre-stopgap law) that the numerator of the foreign tax credit limitation fraction (foreign source taxable income) is computed on a phase-by-phase basis. Thus, a company taxable on only its investment income (i.e., a phase-one company) would receive no foreign tax credit for premium taxes if all of its investment income were U.S. source income, even if the investment income arose from reserves held with respect to foreign business. Some taxpayers have taken the position that application of a phase-by-phase foreign tax credit limitation is improper under pre-stopgap law.

Explanation of Provision

Elimination of the present law three-phase system presupposes that gross premium income and gross investment income contribute in similar ways to total income. The committee believes that certain deductions generally bear the same relationship to gross premium income that they bear to gross investment income. Similarly, these deductions generally bear the same relationship to gross U.S. source income that they bear to gross foreign source income. These deductions should, therefore, generally reduce U.S. source gross income and foreign source gross income ratably in calculating the foreign tax credit limitation. Similarly, reserve decreases should generally produce U.S. source gross income and foreign source gross income ratably.

Under its general rule, the bill provides that in calculating U.S. source income and foreign source income, three items will be treated under regulations as items which cannot definitely be allocated to an item or class of gross income. Thus, these items will be allocated ratably among all classes of gross income. These items are policyholder dividends (determined under new section 808(c)), reserve adjustments (under subsections (a) and (b) of new section 807), and death benefits and other amounts described in new section 805(a)(1).

The following example illustrates the application of the bill's general rule to a life insurance company that has $2,100 of gross income from all sources (including $100 of income from a net reserve decrease) and $1,800 of expenses (consisting of a death benefits deduction of $1,200 [illegible] a policyholder dividends deduction of $600):

Gross Income	U.S. Source	Foreign Source	Worldwide
Investment	$700	$300	$1,000
Premiums	600	400	1,000
Total	1,300	700	2,000
Percent	(65)	(35)	
Items subject to ratable allocation:			
Income from net reserve decrease	65	35	100
Death benefits deduction	(780)	(420)	(1,200)
Policyholder dividends deduction	(390)	(210)	(600)
Worldwide net income	195	105	300

Under the bill's general rule, these items will be allocated in this way regardless of the current residence of the decedents whose deaths caused the death benefit payments, the source of the premiums those decedents had paid the company in any year, the residence of the policyholders receiving or crediting dividends, or any other factor.

In some cases, the bill's general rule could be inequitable in its application to companies that can easily identify gross income to which these expenses relate. Therefore, taxpayers will be able to elect to treat the expenses that are the subject of the general rule of the bill as properly apportioned or allocated among items of gross income in the manner and to the extent prescribed in regulations. The election will apply for all taxable years of the taxpayer to which the bill applies. It must be made on or before September 15, 1984. Once made, it will be irrevocable, except with the consent of the Commissioner.

For example, a foreign country may require life insurance companies that sell policies there to maintain reserves there. In such case, a taxpayer could show that some deductions for reserve increases, policyholder dividends, and claims should be treated as properly apportioned or allocated among items of gross income. In addition, a taxpayer could show that some such deductions should be treated as properly apportioned or allocated to some portion of the company's investment income attributable to the company's worldwide surplus. However, a taxpayer who makes such showings will not be able to show that those deductions are properly apportioned or allocated solely to an undue amount of foreign source investment income. For example, a company whose worldwide surplus is 15 percent of reserves and that makes the election will not be able to show that any of these deductions are properly apportioned or allocated solely to foreign source investment income (from any foreign country) attributable to surplus above 15 percent above reserves that the company must maintain in a foreign country.

The election will not apply to the special life insurance company and small life insurance company deductions. All companies will treat these deductions as items which cannot definitely be allocated to an item or class of gross income.

j. Foreign life insurance companies' minimum surplus (new sec. 813)

Present Law

Foreign corporations in general

Foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States. The United States generally imposes a flat 30-percent tax on the gross amount of U.S. source investment income (and certain other U.S. source income) paid to foreign persons when that income is not effectively connected with a U.S. trade or business. The tax on gross amounts of interest, dividends, and royalties may be reduced or eliminated under bilateral income tax treaties.

Taxation of foreign life insurance companies in general

A foreign corporation carrying on an insurance business within the United States that would qualify as a life insurance company if it were a U.S. corporation is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any

U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

Effectively connected income of a foreign corporation carrying on an insurance business within the United States includes all income (such as investment income attributable to required reserves) from foreign sources that is attributable to the U.S. business.[15] Such a foreign corporation is taxable at the 30 percent or lower treaty rate on its U.S. source investment income that is not effectively connected with a U.S. trade or business.

A foreign life insurance company that is engaged in a U.S. trade or business is taxable on U.S. source underwriting income but not on foreign source underwriting income (unless that foreign source underwriting income is effectively connected with a U.S. trade or business).

Minimum surplus requirement

A special rule may alter the U.S. tax on foreign life insurance companies doing business in the United States when they hold a relatively small surplus attributable to the U.S. business in the United States. This rule applies when the surplus of a foreign life insurance company held in the United States is less than a specified minimum. That minimum amount is the foreign company's total insurance liabilities on U.S. business multiplied by the ratio of the average surplus of domestic corporations to their total liabilities. The Secretary of the Treasury determines this ratio each year.

If the foreign insurance company's surplus held in the United States is less than this minimum amount, then certain deductions of the company decrease. The policy and other contract liability requirements, and the required interest for computing gain from operations, are reduced by the deficiency multiplied by the current earnings rate. An increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business. The reason for reduction in the flat-rate tax is that part of that investment income, in effect, may be income subject to tax under the minimum surplus adjustment.

For the purpose of this minimum surplus requirement, Regulations provide for a separate computation of surplus with respect to segregated asset accounts of foreign life insurance companies. For such accounts, in general, the required surplus is 1 percent of liabilities (Treas. reg. sec. 1.819-2(b)(4)).

Explanation of Provision

The bill generally retains the Secretary's ratio adjustment, with modifications. A foreign company taxable as a life insurance company must compare its surplus held in the United States to a required surplus computed under the new statute. If the required surplus exceeds the actual surplus, the company must increase its tentative LICTI by the product of that excess and its current investment yield.

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[15] Some Canadian insurance companies contended that the U.S.-Canada income tax treaty exempts from U.S. tax passive income they receive from Canadian sources, even when that passive income is effectively connected with and attributable to a U.S. business. The Court of Claims has rejected that contention (Great-West Life Assurance Co. v. United States, 82-1 USTC para. 9374 (1982)).

The bill requires the calculation of required surplus in a manner similar to the calculation of the "minimum figure" under present law. The Secretary of the Treasury is to calculate the percentage used in the taxpayer's calculation in a manner similar to the manner of present law. Taxpayers will calculate current investment yield by dividing net investment income on assets held in the United States by the mean of assets held in the United States. For this purpose, only, the taxpayer is to use amounts required to be set forth on the NAIC annual statement.

The bill also provides definitions of surplus held in the United States and total insurance liabilities. Surplus held in the United States is the excess of assets held in the United States over the total insurance liabilities on U.S. business. For the purpose of valuing assets in the determination of surplus, the committee intends that the Secretary promulgate regulations that indicate that taxpayers are not to value assets under the method used in the NAIC statement, but are to use a method similar to the method prescribed under present law. Total insurance liabilities mean the sum of total reserves (as defined in new sec. 816(c)) plus, to the extent not included in total reserves, the items referred to in paragraphs (3), (4), (5), and (6) of new section 807(c). The Committee intends that the Secretary adopt regulations governing required surplus attributable to segregated asset accounts similar to the regulations in effect under current law.

As under present law, an increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business.

The bill provides a new rule for foreign mutual life insurance companies that reflects the equity base concept of the new statute. Each such company that is taxable as a life insurance company in the United States is to increase its equity base by the excess (if any) of its required surplus over its actual surplus.

k. Contiguous country branches of U.S. life insurance companies (new section 814)

Present Law

U.S. corporations are taxable on worldwide income, including foreign income (although the foreign tax credit may offset U.S. tax on foreign income). In general, foreign corporations (even those wholly owned by U.S. persons) are not subject to U.S. tax on foreign income. U.S. shareholders of a foreign corporation generally are exempt from U.S. tax on the earnings of the foreign corporation until it pays them a dividend (unless it engages in tax-haven or tax avoidance activity). Foreign branch operations of U.S. taxpayers generally are subject to tax currently.

Branches of mutual companies generally derive their income from the issuance of policies on local risks and from investment income from reserves on local risks. Under the principle of mutuality, this income inures solely to the benefit of local policyholders. Thus, a foreign branch of a mutual life insurance company is similar to a foreign corporation owned by non-U.S. persons. Congress, therefore, provided that a U.S. mutual life insurance company may generally elect to exempt the income of its branches that operate in Canada or Mexico (sec. 819A)[16] so long as the foreign branch does not repatriate its income to the United States. Repatriation of contiguous country branch income results in an increase in life insurance company taxable income. In this respect, the treatment of contiguous country branches corresponds generally to the treatment of foreign subsidiaries of U.S. parent companies.

In general, a transfer of property by a U.S. person to a foreign corporation can qualify for nonrecognition treatment only if the exchange does not have as one of its principal purposes the avoidance of U.S. tax (sec. 367). A special rule applies (1) to elections by U.S. mutual life companies to use the special contiguous country branch rule and (2) to certain incorporations by U.S. stock life companies of contiguous country subsidiaries. In general, in each case, there is a deemed sale of the invested assets and tangible property subject to the election or transferred in the incorporation. The gain that the company must recognize is the excess of the fair market value of those invested assets and that tangible property over their aggregate adjusted basis. The company does not recognize gain attributable to goodwill, since it is an intangible asset.

Explanation of Provision

The bill retains the contiguous country branch rule of present law, with technical modifications. Thus, repatriation of contiguous country branch income will result in an increase in tentative LICTI. As under present law, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g., home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person. For this purpose the rules in the Internal Revenue Code (sec. 482) dealing with reimbursement of costs between related parties continue to apply and the domestic company must establish procedures for billing the branch at arm's length. As under present law, reimbursements under this provision are not treated as repatriation of income.

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of the domestic company they are to be added to the tentative LICTI of the domestic company except to the extent the transfers are reimbursements for home office services. The amount added to the tentative LICTI cannot exceed the amount by which the aggregate decrease in the tentative LICTI for the taxable year and for all prior taxable years resulting solely from the application of these exclusion provisions with respect to the contiguous country branch exceeds the amount of additions to the tentative LICTI with respect to that branch which were treated as a repatriation of income for all prior taxable years. For this purpose, in the case of a prior taxable year beginning before January 1, 1983, "tentative LICTI" means life insurance company taxable income computed under the law in effect during the earlier taxable year.

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[16] For the legislative history of these life insurance company provisions, see H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 248-252, and S. Rep. No. 94-938, 94th Cong., 2d Sess. 271-275.

Section 113 of the bill provides that an election under section 819A of current law will be treated as an election under new section 814, and that references to new section 814 will be treated as references to the corresponding provision of section 819A of current law.

l. Rules relating to capital gains and losses (new sec. 818)

Present Law

With respect to property used in a trade or business and held for more than 12 months, present law provides, in general, that if the gains from the sale or exchange of such property exceed such losses, then each gain and loss is treated as though it was from the sale or exchange of a long-term capital asset. If the losses exceed the gains, then each gain or loss is considered as not being from the sale or exchange of a capital asset, with the result that ordinary gain or loss is realized.

In the case of life insurance companies, a special rule applies which modifies the general rule by limiting the term "property used in the trade or business" to include only property used in carrying on an insurance business. Further, for purposes of section 1221(2) (excluding certain property from the term "capital assets"), the reference to property used in trade or business is treated as including only property used in carrying on an insurance business. In both cases, the term "property used in carrying on an insurance business" means only those assets used in the operation of the insurance trade or business.

Under present law, the amount of gain that is recognized on the sale or other disposition of certain property acquired before December 31, 1958 is limited. In the case of property acquired after December 31, 1958, having a substituted basis (within the meaning of sec. 1016(b)), the limitation on the gain recognized shall apply if the property or properties were held only by life insurance companies during the relevant periods. The term "property" does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221 relating to stock in trade or inventory-type property.

Explanation of Provision

The bill continues the present law treatment relating to capital gains and losses and gains and losses on property used in the trade or business for life insurance companies. These rules are found in new section 818(b), (c), and (d).

Under the present law provisions, there are regulations for assumption reinsurance transactions which are generally treated as a sale of a block of business. The bill continues the current distinction between indemnity and assumption reinsurance arrangements.

m. Technical and conforming amendments (sec. 211(b) of the bill)

Section 211(b) of the bill contains 27 technical changes to the provisions of the Internal Revenue Code of 1954 outside of Part I of subchapter L. These amendments conform the existing provisions of the 1954 Code to the new single phase tax system adopted for life insurance companies under the bill.

n. Effective date and transitional rules (secs. 215, 216, and 217 of the bill)

Effective Date

Generally, the life insurance company taxation provisions apply to taxable years beginning after December 31, 1983.

Transitional Rules

Reserves computed on a new basis

As of the beginning of the first taxable year after December 31, 1983, the reserve for any contract shall be recomputed as if the amendments made in this bill had applied to such contract when it was issued.

Any change in accounting (e.g., in computing the policyholder dividends deduction) or any change in the method of computing reserves which is required by the amendments made in this bill will not be treated as a change in the method of accounting or in the method of computing reserves, and will not give rise to income or loss. This "fresh start" provision will apply solely to changes made between any company's first taxable year beginning after December 31, 1983, and the preceding taxable year.

This "fresh start" rule is not applicable to any recomputation of reserves for risks transferred pursuant to a reinsurance agreement entered into, modified or terminated after September 27, 1983. Also, the "fresh start" rule does not apply to any reserve strengthening after September 27, 1983. For these purposes, the phrase "any reserve strengthening" is intended to refer to the computation of reserves on new business at an interest rate that is lower than the rate assumed in the contract and to strengthening of reserves for tax purposes on existing business. Thus, any election to revalue reserves under present-law section 818(c) that is made on a return filed after September 27, 1983, and increases the reserves for tax purposes, will be considered reserve strengthening under this provision. Under the bill, any income arising from the nonapplication of the "fresh start" rule will be taken into account over 10 years and will be added to income ratably in each year after determining the amount of the special life insurance company deduction and the small life insurance company deduction. The bill also provides that if expenses have been transferred between insurance companies pursuant to a reinsurance agreement that is entered into, modified, or terminated after September 27, 1983, any income attributable to those expenses and taken into account in a later year cannot be taken into account for purposes of determining the amount of the special life insurance company deduction and the small life insurance company deduction.

If a life insurance company changed its method of computing reserves in any taxable year beginning before 1984, the resulting income or loss will not be taken into account in any taxable year beginning after 1983. Thus, a company that changed its reserve method in a manner that reduced the reserves before adoption of the new Federally prescribed reserve rules, will not be treated differently than a company whose reserves for tax purposes are reduced by the bill.

Installment contracts

If, prior to January 1, 1984, an election is made to treat income from an installment obligation as investment income, any income from such obligation shall be treated as attributable to a noninsurance business. Noninsurance business is defined as any trade or business which is not an insurance business, however, any noninsurance business that traditionally has been carried on by life insurance companies for investment purposes shall be treated as an insurance business.

Determination of tentative LICTI in cases of acquisitions in 1980, 1981, 1982 and 1983.—In certain specific cases that involve the acquisition of 1 or more insurance companies, a transitional rule is provided which permits increases in tentative LICTI. In order to qualify, a corporation domiciled in Alabama, Oklahoma or Texas had to acquire the assets of one or more insurance companies after 1979 and before April 1, 1983. In addition, the bases of the acquired assets in the hands of the acquiring corporation were determined under sec. 334(b)(2) (relating to the basis of property received in complete liquidation of a subsidiary) or the corporation made an election under sec. 338 (relating to the treatment of stock purchases as asset acquisitions). If those tests are met, and the names of the acquiring and acquired corporations were set forth in submissions dated before October 19, 1983, then the tentative LICTI of the corporation holding the assets for taxable years after December 31, 1983, shall be increased by the deduction allowable for the amortization of the cost of insurance contracts acquired in the acquisition and for any portion of any operations loss deduction attributable to such amortization.

The effect of the increase in tentative LICTI is to increase the base for the 60 percent (of the first $3 million) small life insurance company deduction and the 25 percent special life insurance company deduction.

Pursuant to the memorandum submitted to the Committee on Ways and Means before October 19, 1983, the following acquiring companies will receive the special treatment available in this provision:

Liberty National Life Insurance (Alabama)
American Standard Life Insurance (Oklahoma)
American Trustee Life Insurance (Oklahoma)
First Life Assurance (Oklahoma)
Metroplex Life Insurance (Texas)

Transport Holding Life Insurance (Texas)
Tenneco Texas Life Insurance (Texas)
Tenneco Texas General Life Insurance (Texas)
American General Corporation (Texas)
LIC Life Insurance Company (Texas)

Special allocation rule for reinsurance agreements

Any contract that was issued before September 27, 1983, which is reinsured before that date under a reinsurance agreement entered into before September 27, 1983, will not be subject to the allocation and recharacterization authority is granted the Secretary of the Treasury in section 811(d) of this bill.

Treatment of a stock-mutual company

Any company that has been operating for a ten-year period ending on December 31, 1983, as a mutual life insurance company with shareholders, as authorized by the law of the State in which it is domiciled, shall be treated as a stock life insurance company, except that such company shall be treated as a mutual life insurance company with respect to the mutual portion of it's equity base. In any calendar year, the mutual portion of items of gain from operations, equity base, dividends to policyholders, assets, reserves, and any other items shall be determined as prescribed for reporting in the annual statement.

3. Taxation of Life Insurance Products

a. Definition of life insurance contract (new sec. 7702)

Present Law

Generally, there is no statutory definition of life insurance under present law. A life insurance contract is defined generally in section 1035 (relating to tax-free exchanges) as a contract with a life insurance company which depends in part on the life expectancy of the insured and which is not ordinarily payable in full during the life of the insured.

Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, but it is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract, i.e., the sum of all premiums paid on the contract. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

In TEFRA, Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life) qualified as life insurance contracts for purposes of the exclusion of death benefits from income. Violation of the guidelines at any time during the contract causes the contract to be treated as providing a combination of term life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

1982 and 1983 temporary guidelines

Under the temporary guidelines which apply to 1982 and 1983, death proceeds from flexible premium life insurance contracts are treated as life insurance if either of two tests are met.

Alternative 1

Under the first of the two alternative tests, a contract qualifies if:

(a) The sum of the premiums paid for the benefits at any time does not exceed the net single premium (based on interest rates at 6 percent) or the sum of the net level premiums (based on interest rates at 4 percent), assuming the policy matures no earlier than in 20 years or at age 95, (if earlier); and

(b) the death benefit is at least 140 percent of cash value at age 40, phasing down one percentage point each year to 105 percent.

Alternative 2

Under the second of the two alternative tests, a contract qualifies if the cash value does not exceed the net single premium (based on interest rates at 4 percent) for the amount payable at death, assuming the policy matures no earlier than in 20 years or at age 95, (if earlier).

Explanation of Provision

The bill adopts a definition of a life insurance contract for purposes of the Internal Revenue Code. This provision extends to all life insurance contracts rules that are similar to those contained in the temporary provisions of TEFRA. Since the committee was concerned with the proliferation of investment-oriented life insurance products, the definition has been narrowed in some respects.

Definition of life insurance

A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes.

The term "life insurance contract" does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. Thus, although a life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the life insurance contract for tax purposes and such annuity benefits may not be reflected in computing the guideline premiums. Thus, an insurance arrangement written as a combination of term life insurance with an annuity contract, or with a premium deposit fund, is not a life insurance contract for purposes of the guidelines because all of the elements of the contract are not treated under State law as providing a single integrated death benefit. As a result, only the term portion of any such contract can meet the tests and be treated as life insurance proceeds upon the insured's death. However, any life insurance contract that is treated under State law as a single, integrated life insurance contract and that satisfies these guidelines will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits.

In the case of variable life insurance contracts (as defined in sec. 817), the determination, as to whether the contract meets the cash value accumulation test, or the guideline premium requirements and falls within the cash value corridor, shall be made whenever the amount of the death benefits under the contract change, but not less frequently than once during each 12-month period. Further, if a contract is checked to see if it satisfies the requirements once a year, the determination must be made at the same time each year.

Cash value accumulation test

The first alternative test under which a contract may qualify as a life insurance contract is the cash value accumulation test. This test is intended to allow traditional whole life policies with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts. Certain contracts that have been traditionally sold by life insurance companies, such as endowment contracts, will not continue to be classified as life insurance contracts because of their innate investment orientation.

Under this test, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Cash surrender value is defined in the bill as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend. For these purposes, termination dividends will be considered reasonable based on what has been the historical practice of the industry in paying such dividends. Historically, termination dividends have been modest in amount. For example, the committee understands that New York State prescribes a maximum termination dividend of $35 per $1000 of face amount of the policy. Just as termination dividends are not reflected in the cash surrender value, any policyholder dividends left on deposit with the company to accumulate interest is not part of the cash surrender value of a contract; interest income on such dividend accumulations is currently taxable to the policyholder because the amounts are not held pursuant to an insurance or annuity contract. The term future benefits under the bill means death benefits and endowment benefits. The death benefit is the amount that is payable in the event of the death of the insured, without regard to any qualified additional benefits.

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time will be computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. With respect to variable contracts that do not have a guaranteed rate, then the 4-percent rate shall apply. The mortality charges taken into account in computing the net single premium will be those specified in the contract or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract. The amount of any qualified additional benefits will not be taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit will be treated as a future benefit, thereby increasing the cash value limitation by the discounted value of such charge. For life insurance contracts, qualified additional benefits are guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit will be taken into account. For example, if a contract provides for business term insurance as an additional benefit, neither the term insurance nor the charge for the insurance will be considered a future benefit.

Guideline premium and cash value corridor test requirements

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium requirement and the cash value requirement. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder. The second requirement, the cash value corridor, disqualifies contracts which build up excessive amounts of cash value (i.e., premiums and income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which both require or permit only relatively modest investment and yield relatively modest investment returns.

The specifics of these requirements are described below.

Guideline requirements.—A life insurance contract will meet the guideline premium requirements of the second test if the sum of the premiums paid under the contract does not at any time exceed the greater of the sum of the guideline level premiums to such date or the guideline single premium. The guideline single premium for any contract is the premium at issue required to fund future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or used in determining the statutory reserves for the contract if none is specified in the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the minimum rate or rates guaranteed on the issuance of the contract. The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract. The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year but only if the contract would terminate without cash value but for such payment. Also, if it is established to the satisfaction of the Secretary that the requirement was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the first requirement. Premium amounts returned to a policyholder, with interest, within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income. This "hold harmless" provision in the event of a timely correction is comparable to similar provisions elsewhere in the Code.

Cash value corridor.—A life insurance contract will fall within the cash value corridor test if the death benefit under the contract at any time is equal to at least the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As the table shows, the applicable percentage to determine the minimum death benefit starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and the percentage decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage will decrease by the same amount for each year in that age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage will be 142.

The statutory table of applicable percentages follows.

In the case of an insured with an attained aged as of the beginning of the contract year of:		The applicable percentages shall decrease by a ratable portion for each full year:	
More than—	But not more than—	From—	To–
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

Computation of benefits

In computing the benefits under any contract, the death benefit shall be deemed not to increase at any time during the life of the contract (qualified additional benefits will be treated in the same way). Thus, a contract cannot assume a death benefit that is level, then decrease only to increase again in order to allow earlier funding of an increased future benefit, thus avoiding the premium guideline limitation. Further, the maturity date shall be deemed to be no earlier than the day on which the insured attains age 95.

This rule generally prevents contracts endowing before age 95 from qualifying as life insurance. The amount of any endowment benefit, or the sum of any endowment benefits, shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

Notwithstanding the first computational rule, under certain circumstances, an increase in the death benefit (which is provided in the contract) may be taken into account for purposes of meeting the two definitional tests provided by the bill. Specifically, in computing the guideline level premium (only) for a contract, an increasing death benefit may be recognized to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value. Under a similar modification of the cash value accumulation test, the cash surrender value cannot exceed at any time the net level reserve. For this purpose, the net level reserve would be determined as though level annual premiums were paid for the contract until the insured attains age 95. These modifications to the computational rules would allow the sale of contracts where the death benefit is defined as the cash surrender value plus a fixed amount of pure life insurance protection.

Adjustments

Changes in the terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. In the event of such a change, the limitations under the alternative tests must be recomputed for purposes of determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the bill. Under the bill the Secretary of the Treasury has authority to presribe regulations governing how such recomputations should be made. Further, there is a special provision that any change in the terms of a contract that reduces the future benefits under the contract shall be treated as an exchange of contracts (under sec. 1035), and so may give rise to a distribution taxable to the policyholder.

Contracts not meeting the life insurance definition

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for any taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of life insurance protection provided during the taxable year under the contract exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The term premiums paid means the amounts paid as premiums under a contract less amounts to which the rules for allocation between income and investment under annuity and other contracts in section 72(e) apply. Because the income on the contract is treated as received by the policyholder, the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present law relating to commercial annuities (including life insurance). It is hoped this will provide the policyholder with adequate notice that disqualification has occurred, thus giving some protection against underpayment of estimated taxes.

The income on the contract for all prior taxable years will be treated as received or accrued during the taxable year in which a life insurance contract ceases to meet the definition of a life insurance contract. The cost of life insurance protection provided under any contract will be the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums, computed using 5-year age brackets, as prescribed by the Secretary by regulations, or the mortality charge stated in the contract.

The excess of the amount of death benefit paid over the net surrender value of the contract will be treated as paid under a life insurance contract for purposes of the exclusion from income with respect to the beneficiary.

Endowment contracts which meet the requirements of the definition of a life insurance contract will receive the same treatment as a life insurance contract. If a life insurance contract fails to meet the tests in the definition, it will nonetheless be treated as an insurance contract for tax purposes. This insures that the premiums and income credited to failing policies will continue to be taken into account by the insurance company in computing its taxable income. In addition, it insures that a company that issues failing policies continue to qualify as an insurance company.

Effective Date

General effective date

Generally, the new definition of life insurance applies to contracts issued after December 31, 1983. Contracts issued in exchange for existing contracts after December 31, 1983 are to be considered new contracts issued after that date.

Transition rules

Contracts issued during 1984.—Any insurance contract that is issued during 1984 will be treated as meeting the definitional requirements of a life insurance contract if the contract meets: (1) the requirements of the temporary provisions enacted in TEFRA, or, (2) for a contract that is not a flexible premium life insurance contract (defined under section 101(f)), the requirements set forth in this bill by substituting 3 percent for 4 percent as the minimum interest rate to be used in the cash value accumulation test.

Contracts issued pursuant to existing plans of insurance.—Under another transition rule, certain qualified contracts under existing plans of insurance will qualify as life insurance contracts under the cash value accumulation test, discussed above, if the contracts would meet the test using 3-percent, instead of 4-percent, as the minimum interest rate. A "qualified contract" will mean any contract that requires at least 20 nondecreasing annual premium payments and is issued pursuant to an existing plan of insurance, which is any plan of insurance or policy blank that has been filed by the issuing company in one or more States before September 28, 1983. It is intended that the 20-pay requirement will not be violated by a plan of insurance that provides for the purchase of insurance by means of paid-up additions, if the additional amounts are modest and reasonable compared with the basic benefit under the contract.

b. Treatment of certain annuity contracts (sec. 72)

Present Law

Cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty is not imposed if the distribution is made after the contract holder attains age 59½, when the contract holder becomes disabled, upon the death of the contract holder or as a payment under an annuity for life or at least 5 years. No income is recognized to the recipient of an annuity on the death of the contract holder. However, since the recipient has the same investment in the contract as the deceased contract holder, the recipient is subject to income tax on the income accumulated in the contract prior to death when it is distributed from the contract.

Explanation of Provision

Penalty on premature distributions

However, the bill generally retains the present-law provisions for annuity contracts. The 5-percent penalty on premature distributions will apply to any amount distributed to the taxpayer before the age of 59½ without regard to whether the distribution is allocable to an investment made within 10 years. This is consistent with a general objective of the bill to encourage retirement savings as opposed to short term savings.

Distribution in event of annuity holder's death

In the event that the owner of any annuity contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract shall be treated as paid to the contract holder immediately before death. Thus, the income in the contract will be subject to income tax in the decedents return for the year of death. To prevent a second taxation when amounts are actually distributed to the new owner, the amount deemed to be distributed under the contract, that is, the amount includible in gross income of the decedent, is treated as a premium paid for the contract. The 5-percent penalty tax on a premature distribution from an annuity shall not apply to any amount includible in gross income because of the deemed distribution in the event of the contractholder's death.

This amendment will not apply to amounts received under contracts issued under qualified plans. For this purpose qualified plans are plans that have received employer contributions that were deductible from gross income when made.

Effective Date

These amendments to the annuity rules shall apply to contracts issued after the day which is six months after the date of enactment.

c. Policyholder loans (new sec. 264(d))

Present Law

Generally, taxpayers are allowed to deduct interest paid or accrued on indebtedness during the taxable year. However, no deduction is allowed for (1) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract; (2) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract that is treated as a single premium contract) pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of such contract.

There are a number of exceptions to the rule disallowing a deduction for interest on indebtedness incurred or continued with respect to a contract other than a single premium contract or a contract that is treated as a single premium contract. Under the exceptions, a deduction is allowed if (1) no part of four of the first seven annual premiums due under the contract is paid by means of indebtedness; (2) the total of the amounts paid or accrued during the taxable year does not exceed $100; (3) the amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or an unforeseen increase in financial obligations; or (4) the indebtedness was incurred in connection with the taxpayer's trade or business. If the requirements of any one of these four exceptions are satisfied, a taxpayer can deduct the full amount of interest otherwise deductible on an unlimited amount of indebtedness.

Explanation of Provisions

The bill amends present law by adding a limitation on the amount of interest that is deductible. Thus, amounts that are not deductible under present law are not deductible under the bill.

The applicable limits

Under the bill, individual policyholders, and businesses owning policies insuring the lives of individuals are allowed to deduct, for any taxable year, an amount of life insurance interest equal to the applicable limit for such taxable year. Life insurance interest is defined as interest paid or accrued in connection with a life insurance loan. A life insurance loan is any indebtedness if (1) the interest paid or accrued with respect to such indebtedness would, but for this provision, be deductible (i.e., the transaction is not a disguised distribution of the cash value of the policy); and (2) the indebtedness is (a) incurred under, or secured by, a life insurance, endowment, or annuity contract, or (b) incurred or continued to purchase or carry a life insurance, endowment or annuity contract.

This definition of a life insurance loan is provided, in part, to clarify that interest paid on a loan from a third party secured by the cash value of a life insurance contract is deductible only if it is deductible under section 264 and under the limitations contained in this provision.

The applicable limit for an individual policyholder for any taxable year is an amount equal to the product of $250,000 ($500,000 in the case of a joint return) multiplied by the deficiency rate prescribed under section 6621 in effect as of the first day of the taxable year. The applicable limit for a business is the product of $500,000 multiplied by the section 6621 deficiency rate for each qualified life. Although the committee recognizes that the use of the deficiency rate will result in changing limits for various years, it believes such a rule is necessary in order to administer this provision and may be accommodated by variable rate loans under life insurance contracts.

Business taxpayers

For purposes of this provision, the $500,000 business limitation is for corporations, partnerships, proprietorships, or other entities engaged in a trade or business. An unincorporated trade or business operated by an individual constitutes a proprietorship. Businesses may deduct interest subject to an aggregate limitation based on the number of qualified lives.

Qualified lives are defined in the bill by reference to the amount of coverage provided as a percentage of the maximum amount provided under a policy owned by the business. Under the bill, a "qualified life" is an individual insured under a life insurance policy owned by a corporation, partnership, proprietorship or other entity engaged in a trade or business if (1) at some time during the taxable year, the life of the individual is insured under a whole life policy owned by the business, and (2) the face amount of such policy is at least as 10 percent of the highest face amount of a whole life policy owned by the business and insuring the life of any other individual. Thus, if a corporation owns policies insuring the lives of three individuals, and the face amount of two of the policies is $1,000,000 and the face amount of the other is $50,000, the individual with respect to whom the $50,000 policy is held is not a qualified life. Thus, the corporation will be subject to an interest limitation of $2,000,000 times the appropriate deficiency rate.

Carryover of unused limitation

Any excess limitation is carried over and added to the limitation for the succeeding taxable year. Thus, if for any taxable year a taxpayer fails to pay or incur and deduct an amount of interest equal to the maximum deductible amount (the applicable limit), the excess of the maximum amount over the amount that is deducted is added to and increases the maximum deductible amount for the succeeding taxable year. For example, assume that in a particular taxable year a individual not engaged in a trade or business borrows $10,000 at 8 percent and pays and deducts $800 of interest. If the deficiency rate under section 6621 for that year is 11 percent, the individual's unused interest limitation would be $26,700 (i.e., $250,000 X .11 −$800). If the deficiency rate is the same the next year, the individual's limitation for the next taxable year would be $54,200, (26,700 + $250,000 X .11) The unused amounts carryover indefinitely. No carryover arises, however, with respect to a year in which there are no outstanding life insurance loans to the taxpayer or if the loans are on policies not covered by the new provisions adopted by the bill.

Effective Date

The provisions of the bill relating to the deduction of life insurance interest apply with respect to interest paid or accrued in taxable years ending after September 27, 1983. The provision does not apply, however, to any indebtedness incurred under, secured by, or incurred or continued to purchase or carry a life insurance, endowment or annuity contract if such contract was issued before September 28, 1983, or was issued on or after such date pursuant to a binding contract entered into before such date. The limitation on a life insurance loan shall not apply to an existing contract, if the contract is renegotiated after the date of enactment.

d. Group-term life insurance purchased for employees (sec. 79)

Present Law

The cost of group term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. Among the exceptions to this rule is one that applies to terminated employees who have reached retirement age or are disabled. As a result, an employer may provide group-term life insurance for these two groups of former employees in amounts greater than $50,000 without any portion of the costs being included in their gross income.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is not available. In that event the full cost of the group-term life insurance for any key employee is included in the gross income of the employee (based on the uniform cost table).

The cost of an employee's share of group life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets. In the case of an employee who has attained age 64, the cost does not exceed the cost for a 63-year old individual.

Explanation of Provision

A retired employee may continue to be insured under the group-term life insurance plan of his former employer, but only under the terms that would be applicable if he were still an active employee during the taxable year. Thus, the amendment subjects retired employees to the same limitations as active employees. In effect, an employer will no longer be permitted to pay the full costs of as much insurance as is desired on behalf of a retired employee without any of the costs being included in the retired employee's gross income. The amendment, however, does not affect the exception from the limitation for employees who were retired because of a disability.

An additional amendment applies to the insurance costs of any key employee under a discriminatory group-term life insurance plan. Under such a plan, the full amount of the cost of the life insurance paid by the employer for the taxable year will be includible in the gross income of the employee, and the cost attributable to any such key employee may not be determined under the uniform cost table. Instead, the cost of the insurance will be included in income based on the actual cost of life insurance provided.

Effective Date

The amendments made by this section shall apply to taxable years that begin after December 31, 1983.

The amendments made by this section do not apply to any group-term life insurance plan in existence on September 27, 1983. The exception, however, applies only to an individual who is covered by the plan on September 27, 1983, and only with respect to the amount of life insurance coverage of such individual on that date. In addition, any conversion or renewal of the contract shall be treated as a new contract.

4. Nondeductible Contributions to Individual Retirement Plans (sec. 4973 of the Code)

Present Law

An individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity (referred to collectively as "IRAs"). The amount deductible for a taxable year is generally the lesser of 100 percent of compensation for the year or $2,000. The $2,000 deduction limit is increased to $2,250 for a year if (1) at least $250 is provided to the spouse of the individual, and (2) the spouse has no compensation for the year. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA.

An annual excise tax applies to prohibited nondeductible contributions (*i.e.*, excess contributions) held in an IRA. The tax is 6 percent of the balance of the nondeductible contributions. Under present law, an individual is allowed a deduction from gross income for a taxable year if the individual corrects an excess contribution for a previous year by contributing less than the maximum amount allowable as a deduction for the year.[17]

Under present law, an individual is permitted to make a rollover contribution of a distribution from an IRA to another IRA without including the amount of the distribution in gross income. A tax-free rollover is generally allowed if the rollover occurs within 60 days of the date of the distribution. An individual is allowed to make a rollover contribution from an IRA once each year. Rollover contributions are not treated as excess contributions to an IRA and do not reduce the allowable deduction for a taxable year.

Income and gain on amounts held in an IRA are not taxed until distributed. Except in the case of certain correcting distributions or distributions rolled over to another eligible plan, all distributions from IRAs are includible in gross income when received. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional ten-percent income tax. If an individual borrows from an IRA or uses amounts as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply.

Distributions from an IRA must commence no later than the taxable year in which the individual attains age 70½, and special rules require distributions to be made within a prescribed time after the individual's death. Amounts held in an IRA can qualify for exclusions under the estate tax and gift tax rules.

Present law requires that the trustee or issuer of an IRA make annual calendar year reports relating to the status of the IRA.[18]

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[17] The rule allowing a deduction for prior year contributions applies only to the amount of the excess contributions that do not exceed (1) the maximum allowable deduction for the year minus (2) the amounts contributed for the year.

[18] Treas. Reg. sec. 1.408-5.

This report must contain the following information for transactions during the calendar year: (1) the amount of contributions; (2) the amount of distributions; (3) in the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance; (4) the name and address of the trustee or issuer; and (5) such other information as the Commissioner may require. The annual report must be provided (1) to the individual on whose behalf the account is established or in whose name the annuity is purchased and (2) to the Internal Revenue Service.

Explanation of Provision

Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) are not treated as excess contributions subject to the six percent annual excise tax. The nondeductible limit for a taxable year is the least of (1) $1,750, (2) the excess of compensation includible in the individual's gross income for the year over the amount allowable as a deduction under the IRA rules, or (3) the amount of designated nondeductible contributions for the year.

A designated nondeductible contribution is any contribution to an IRA for a taxable year that the individual designates as a nondeductible contribution (up to the nondeductible limit). The designation may be made or revoked up to the day prescribed by law for filing the income tax return for the taxable year, including any extensions of time for filing to which the individual is entitled.

The committee intends that the individual's designation of nondeductible contributions will be made to the trustee or issuer accepting the IRA contributions. This rule is provided to aid the trustee or issuer of an IRA in maintaining records relating to the characterization of IRA amounts as nondeductible contributions, income on nondeductible contributions, and other amounts. The designation is also intended to assist the trustee or issuer in complying with the reporting requirements under the provision and with the annual reporting requirements of present law. With respect to the annual reporting requirements, the committee intends that the financial institution, when reporting contributions to an IRA, will specify the portion of any contribution that is designated as nondeductible contribution.

The trustee or issuer may specify a date by which a designation of nondeductible contributions must be made. For example, the trustee or issuer may specify that the designation must be made at the time the individual makes the IRA contribution. Alternatively, the trustee or issuer could specify a uniform date for final designation, such as April 15.

Under the provision, in any case in which nondeductible contributions are made on behalf of an individual and an individual's noncompensated spouse (within the meaning of the spousal IRA rules), the nondeductible limit for the taxable year may be allocated in any manner. For example, an individual could make contributions of $875 as designated nondeductible contributions to the individual's IRA and contributions of $875 as designated nondeductible contributions to the spousal IRA for the individual's noncompensated spouse. Alternatively, contributions of $1,750 of designated nondeductible contributions could be made to the spousal IRA.

Annual IRA contributions that exceed the sum of the amount allowable as a deduction for the taxable year and the nondeductible limit are treated as excess contributions that are subject to the annual six percent excise tax. Under the provision, if contributions in a later taxable year are less than the sum of (1) the amount allowable as a deduction for the taxable year and (2) the nondeductible limit, excess contributions from the prior year may be applied against the remaining amount allowable as a deduction and the remaining nondeductible limit, in the same manner as under present law. A designated nondeductible contribution could not, however, be recharacterized as a deductible contribution after the time for filing the tax return for the taxable year of the contribution (including extensions).

Under the provision, any amount paid or distributed from an IRA is treated first as paid or distributed from income and gain allocable to designated nondeductible contributions (to the extent thereof), second as paid or distributed out of designated nondeductible contributions (to the extent thereof), and then out of other amounts. If an IRA distribution includes property other than cash, the amount distributed is the fair market value of the property plus the amount of cash distributed. If appreciated property is distributed, the gain allocable to designated nondeductible contributions includes the unrealized appreciation. Losses incurred by an IRA would not be recognized by the IRA owner before all assets of the IRA have been distributed.

In general, any amount paid or distributed from an IRA is included in the gross income of the individual for the taxable year in which the payment or distribution is received. Amounts that are treated as paid or distributed out of designated nondeductible contributions, however, are treated as a return of basis and are excluded from gross income. Similar rules apply to distributions under an individual retirement annuity and, therefore, the general rules relating to the taxation of distributions under individual retirement annuity contracts are inapplicable.

For example, an individual's IRA could have accumulated designated nondeductible contributions of $10,000, income of $1,000 attributable to the designated nondeductible contributions, and other allowable amounts equal to $20,000. If the individual withdraws $15,000 from the IRA during a taxable year, $1,000 would be treated as coming from the income attributable to designated nondeductible contributions, $10,000 as attributable to the designated nondeductible contributions, and $4,000 as attributable to other allowable IRA contributions and income. In this case, the individual would include $5,000 in gross income for the taxable year (*i.e.*, $15,000 minus $10,000 treated as a return of basis). In addition, if the withdrawal occurs prior to the time the individual attains age 59½, dies, or becomes disabled, $5,000 (the amount includible in gross income) is subject to the additional 10-percent income tax on premature distributions.

Under the provision, the trustee or issuer of an IRA is required to maintain any records necessary to account separately for designated nondeductible contributions and for the income and gain attributable to designatd nondeductible contributions. In addition, under regulations prescribed by the Secretary of the Treasury, amounts that are rolled over, tax-free, from one IRA to another IRA must be accounted for in a manner that will retain the character of the amounts as designated nondeductible contributions, income on designated nondeductible contributions, or other amounts.

The committee intends that the trustee or issuer of an IRA will provide a report to the individual on whose behalf an account is established or in whose name an annuity is purchased. This report is to be provided to the individual at the time a payment or distribution is made from the IRA and is to contain information relating to the character (*i.e.*, designated nondeductible contributions, income attributable to designated nondeductible contributions, and other amounts) of the amounts paid or distributed. In addition, the committee intends that a copy of this report is to be supplied to the trustee or issuer of an IRA to which a rollover contribution from another IRA is made so that the character of the amounts rolled over is retained. Similarly, at any time a trustee-to-trustee transfer of IRA funds is made, any information relating to the character of the amounts transferred is to be supplied to the new trustee or issuer.

The report supplied at the time of a payment or distribution from an IRA is to be provided in addition to, and not in lieu of, the annual report required under present law.

Effective Date

The provision is effective for taxable years beginning after December 31, 1983.

5. Studies (sec. 241 of the bill)

Two issues that were of concern to the committee during the entire process of reformulating the tax structure applicable to life insurance companies were (a) the amount of Federal income tax paid by the companies in the life insurance industry and (b) the relative income tax burden borne by mutual and stock companies. The committee decided that it would be necessary to maintain close scrutiny of these two matters, and instructed that analytical reports be prepared on these two subjects.

a. Revenue reports

Each year on July 1, beginning in 1984, the Secretary of the Treasury is instructed to submit a report on the revenues received under the provisions of part 1, subchapter L for the most recent taxable year. The report is to be submitted to the Committee on Ways and Means and the Committee on Finance. Each report will present the aggregate amount of revenue received for the most recent taxable year for which data are available. The revenues are to be compared with the revenue estimates anticipated as a result of the changes made by TEFRA in 1982 and this bill. The reasons for any difference between the actual aggregate revenues and the revenues anticipated when the Acts were adopted are to be presented and analyzed.

b. Report on segment balance and other issues

The impact of new part 1, subchapter L on the different segments and products of the life insurance industry needs to be examined. A full and complete study of the effects of the provisions in this bill has been mandated, and the Secretary of the Treasury is instructed to conduct the study in consultation with the staffs of the Joint Committee on Taxation, the Committee on Ways and Means and the Committee on Finance. The study will examine the operation of the new tax provisions during 1984, 1985 and 1986.

The report shall include an analysis of the relative shares of life insurance company taxes paid by mutual and stock life insurance companies. The report also will consider any other data considered to be relevant by either stock or mutual life insurance companies in determining appropriate segment balance. Among the relevant variables for consideration are the amounts of the following items held by each segment of the industry: equity; life insurance reserves; other types of reserves; dividends paid to policyholders and shareholders; pension business; total assets, and gross receipts.

The study also is to include an analysis of life insurance products and their taxation. In addition, an analysis of whether the tax provisions in part I of subchapter L operate as a disincentive to growing companies will be included. The committee also instructed the Secretary to include in the report an analysis of the extent that taxes paid by stockholders of life insurance companies affect proper evaluation of segment balance.

In order to be able to conduct the study with as complete a fund of information that is possible, the Secretary of the Treasury is given authority to require reporting of data necessary for the study by life insurance companies with respect to the companies and their products.

The final report is to be submitted by January 1, 1989, to the Committee on Ways and Means and the Committee on Finance. Interim reports are to be submitted to the committees not later than July 1, 1986, 1987, and 1988.

6. Revenue Estimates Relating to Title II of the Bill

The estimated receipts for fiscal year 1984 under the life insurance tax amendments in title II of this bill are $2.8 billion, $3.0 billion in fiscal year 1985, and $3.3 billion in fiscal year 1986, or a total of $9.1 billion over the three-year period.

If the stopgap provisions which were enacted in 1982 in TEFRA would be extended without amendment, the estimated receipts in fiscal year 1984 would be $2.0 billion, $2.1 billion in fiscal year 1985, and $2.3 billion in fiscal year 1986, or a total of $6.4 billion over the three years.[19] If the stopgap provisions would be allowed to expire at the end of this year, the revenue estimated for fiscal year 1984 would be $3.0 billion, and at $3.4 billion for fiscal year 1985, and $3.7 billion for fiscal year 1986, or a total of $10.1 billion over the three years.[20]

The nondeductible IRA provisions of the bill would reduce fiscal year budget receipts by $15 million in 1984, $65 million in 1985, $135 million in 1986, $209 million in 1987, and $285 million in 1988.

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[19] The estimates given at the time the conference report on TEFRA was agreed to would have indicated an estimate of $3.3 billion in fiscal year 1984, $3.5 billion in fiscal year 1985, and $3.6 billion in fiscal year 1986 (a total of $10.4 billion over three years) if stopgap were extended.

[20] The estimates for expiration of stopgap given at the time of the TEFRA conference report were $4.6 billion for fiscal year 1984, $4.8 billion for fiscal year 1985, $5.1 billion for fiscal year 1986 (a total of $14.5 billion over the three years).

TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS

A. Limitations on Deduction for Contributions to Private Foundations (Sec. 302 of the bill and Code sec. 170)

Present Law

Percentage limitations

Under present law (Code sec. 170), contributions of cash and ordinary-income property by an individual to public charities or private operating foundations are deductible up to 50 percent of the donor's adjusted gross income. (The 50-percent limitation applies to such contributions made to a private nonoperating foundation only if the donee either redistributes all contributions within a specified period after receipt or qualifies as a "pooled fund" foundation.) For contributions of certain capital-gain property to organizations otherwise qualifying for the 50-percent limitation, the limitation generally is 30 percent. In the case of contributions to private nonoperating foundations (other than the two categories eligible for the 50-percent/30-percent limitations), present law retains the lower percentage (20 percent) that has generally been applicable to private foundations since the 1954 Code (sec. 170(b)(1)(B)).

Contributions by individuals which exceed the 50-percent/30-percent limitations may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years (sec. 170(d)). Under present law, there is no carryover of excess deduction amounts if the 20-percent limitation applies.

Contributions of appreciated property

Under present law, in the case of donations by individuals of capital-gain property to private nonoperating foundations as to which the 20-percent limitation applies, the amount deductible equals the asset's fair market value reduced by 40 percent of the unrealized appreciation (i.e., by 40 percent of the amount by which the value exceeds the donor's basis in the property). In the case of donations by individuals of certain capital-gain property to public charities, etc., where the 30-percent limitation applies, there is no reduction from fair market value.

Reasons for Change

The committee believes that the failure of present law to provide a carryover deduction in the case of excess contributions to private nonoperating foundations merely requires the donor to divide a planned large gift to a nonoperating foundation into smaller amounts contributed over several years. Accordingly, the committee believes that extension of the carryover rules to contributions to nonoperating foundations is not inconsistent with longstanding

Federal tax policy that provides a tax advantage to contributions to public charities and operating foundations.

Because as a general rule public charities and operating foundations directly carry out charitable functions, expend charitable donations more promptly, and have public involvement, support, and supervision, the committee believes that a tax preference for contributions to public charities and operating foundations continues to be appropriate. However, the committee acknowledges the substantial role of nonoperating foundations in private philanthropy and believes that the extent of this tax preference should be narrowed by increasing to 30 percent the deduction limitation for gifts of cash and ordinary-income property to nonoperating foundations.

Finally, the committee believes that deductibility at full fair market value for gifts of appreciated stock to private nonoperating foundations should be permitted in certain situations in which the potential for abuse, including overvaluations, is minimized.

Explanation of Provisions

Carryover of excess contributions

Under the bill, the five-year carryover deduction for excess contributions by individuals (sec. 170(d)) is extended to contributions to private nonoperating foundations.

Percentage limitations

In addition, the 20-percent limitation which applies under present law for charitable contributions by individuals to private nonoperating foundations (and certain other charitable contributions) is increased by the bill to 30 percent in the case of contributions of cash and ordinary-income property. The bill retains the 20-percent limitation for all gifts of capital-gain property except such gifts to public charities or private operating foundations. Thus, gifts of capital-gain property to private nonoperating foundations (including gifts of certain appreciated stock which are deductible under the bill at fair market value) are subject to the 20-percent limitation.

Amount deductible for certain stock

The bill also provides that contributions to private nonoperating foundations of certain qualified appreciated stock are deductible at full fair market value. Thus, the general present-law rule applicable to gifts of capital-gain property to nonoperating foundations, which limits the amount deductible to the asset's fair market value reduced by 40 percent of the unrealized appreciation, will not apply to such contributions of qualified appreciated stock.

The term qualified appreciated stock means any stock of a corporation (1) for which (as of the date of the contribution) market quotations are readily available on an established securities market and (2) which is capital-gain property for purposes of the charitable contribution deduction rules (sec. 170(b)(1)(C)(iv)). The increased deduction under the bill applies only to the extent that the cumulative total of donations by a donor to all private nonoperating foundations of stock in a particular corporation is less than 10 percent of the value of all outstanding stock of that corporation. For this purpose, a donor is treated as making contributions that are made by any member of the donor's family (as defined in sec. 267(c)(4)).

Effective Date

The amendments made by section 302 of the bill apply to contributions made in taxable years beginning after December 31, 1983. The special rule for contributions of qualified appreciated stock will not apply to contributions made after December 31, 1993.

B. Exemption for Certain Operating Foundations from Excise Tax on Investment Income and Expenditure Responsibility Rules (Sec. 303 of the bill and Code secs. 4940 and 4945)

Present Law

Under present law, a private foundation is subject to a two-percent excise tax on the sum of its gross investment income (including interest and dividends) plus net capital gain, less the expenses of earning such amounts (Code sec. 4940). No similar tax is imposed on investment income of public charities.

In the case of grants to organizations other than public charities, a private foundation must exercise expenditure responsibility over the grant in order to avoid the excise tax on taxable expenditures (sec. 4945).

Reasons for Change

The committee believes that private operating foundations which exhibit certain characteristics reflecting substantial public involvement should be exempted from the two-percent excise tax on net investment income, and that foundations making grants to such organizations should not be required to comply with the expenditure responsibility rules. These changes will assist such operating foundations in making direct expenditures for the active conduct of their charitable activities. At the same time, these foundations will remain subject to other private foundation rules, such as the prohibitions on self-dealing and taxable expenditures.

Explanation of Provisions

The bill provides that exempt operating foundations are not subject to the two-percent excise tax on investment income (sec. 4940), and that grants from other foundations to exempt operating foundations are not subject to the expenditure responsibility requirements under section 4945.

The bill defines exempt operating foundation to mean, with respect to any taxable year, any private operating foundation[1] (1)

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[1] In general, a private operating foundation is defined (sec. 4942(j)(3)) as a foundation that expends directly for the active conduct of its exempt activities at least 85 percent of the lesser of (a) its adjusted net income or (b) its minimum investment return (i.e., five percent of the value of its investment assets). Also, the foundation must meet one of three tests relating to its use of assets, operating expenditures, or support. Under the first test, 65 percent or more of the assets of the foundation must be devoted directly to the active conduct of its exempt activities or to functionally related businesses. Under the second test, the organization must normally spend an amount not less than two-thirds of its minimum investment return directly for the active conduct of its exempt activities. Under the third alternative test, the organization must receive at

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which either has been publicly supported (under secs. 170(b)(1)(A)(vi) or 509 (a)(2)) for at least 10 taxable years, or qualified as an operating foundation on January 1, 1983; (2) the governing body of which, at all times during the taxable year, consists of individuals at least 75 percent of whom are not disqualified individuals, and also is broadly representative of the general public; and (3) no officer of the foundation is, at any time during the taxable year, a disqualified individual.

The bill defines disqualified individual as an individual who is (i) a substantial contributor to the foundation; (ii) an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which corporation, partnership, or enterprise is a substantial contributor to the foundation; or (iii) a member of the family of any individual described in (i) or (ii). For this purpose, the term substantial contributor means a person who is described in section 507(d)(2), and the term family has the meaning given to such term by section 4946(d). In determining ownership in a corporation, etc., for purposes of the definition of disqualified individual, the constructive ownership rules of sections 4946(a)(3) and (4) apply.

Effective Date

The exemption from the section 4940 excise tax for certain operating foundations applies to taxable years beginning after December 31, 1983. The exemption from the expenditure responsibility rules applies to grants made after 1983.

C. Reduction in Section 4940 Excise Tax Where Charitable Payout Increases (Sec. 304 of the bill and Code sec. 4940)

Present Law

The Tax Reform Act of 1969 imposed a four-percent excise tax on the net investment income of private foundations, i.e., on the sum of gross investment income (including interest and dividends) plus net capital gain, less expenses of earning such income (Code sec. 4940). The tax was imposed so that foundations would share some of the costs of government, particularly the costs of administering the tax laws relating to exempt organizations. In the Revenue Act of 1978, the Congress reduced the tax rate to two percent, noting that the prior rate had produced more than twice the revenue needed to finance administration by the Internal Revenue Service of the exempt organization provisions of the Code.

Present law (sec. 4942) in effect requires a private nonoperating foundation to make qualifying distributions, by the end of the following year, at least equal to five percent of the value of its investment assets for the year, less the amount of section 4940 tax on the foundation's net investment income for the year. The payout rules under section 4942 do not apply to private operating foundations;

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least 85 percent of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization.

however, to qualify for operating status, a private foundation must meet certain payout requirements.[2]

Reasons for Change

The committee was informed that the amount of taxes collected under section 4940 during fiscal year 1982 totalled approximately $93 million. The Internal Revenue Service estimates that the total costs of administering the combined exempt organization and employee plan programs in fiscal year 1982 were approximately $84.5 million, of which $33.4 million was for exempt organizations and about $51.1 million for employee plans.

Thus, section 4940 excise tax collections continue to exceed the costs of administering not only the exempt organization program, but also the employee plan and exempt organization programs combined. The amounts raised by this excise tax are not earmarked for the administration of these programs; rather, they go into general revenues. The amount of funds available to the Internal Revenue Service generally continues to depend on annual Treasury appropriations.

In light of these considerations, the committee believes that the rate of the section 4940 excise tax should be reduced from two percent to one percent, but only where there is an equivalent increase in the foundation's qualifying distributions for charitable purposes.

Explanation of Provision

The rate of the section 4940 excise tax imposed on the net investment income of a private foundation is reduced from two percent to one percent for any taxable year if the amount of qualifying distributions[3] made by the foundation during such taxable year equals or exceeds the sum of (a) an amount equal to the foundation's assets[4] for such taxable year multiplied by the average percentage payout for the base period, plus (b) one percent of the foundation's net investment income for such taxable year. The tax rate is not reduced for a year if the foundation's average percentage payout for the base period is less than five percent (3-1/3 percent in the case of a private operating foundation).

A foundation's percentage payout is computed for a year by dividing (i) the amount of qualifying distributions made by the foundation during the taxable year, by (ii) the foundation's assets for the taxable year. (If the amount of section 4940 tax for any taxable year in the base period is reduced by reason of this provision, the amount of qualifying distributions made by the foundation during such year is to be reduced for purposes of this computation by the amount of such reduction in tax.) The average percentage payout for the base period is the average of the percentage payouts for taxable years in the base period.

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[2] See note 1, *supra*.

[3] For this purpose, the term qualifying distribution has the same meaning as in section 4942(g).

[4] The assets of the foundation, for this purpose, equal the excess of (1) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purposes, over (2) the acquisition indebtedness with respect to such assets (determined under sec. 514(c)(1) without regard to the taxable year in which the indebtedness was incurred).

In general, the base period is the five taxable years preceding the current year. If a private foundation has not been in existence for five years, the base period consists of the years during which the foundation was in existence.

In the case of a private foundation which is a successor to another foundation, the experience of the predecessor is to be taken into account in applying this provision. Treasury regulations are to prescribe rules for applying this provision where there has been a merger, reorganization, or division of a private foundation.

Effective Date

The amendment made by section 304 of the bill applies to taxable years beginning after December 31, 1983.

D. Amendments to Payout Requirements (Sec. 305 of the bill and Code sec. 4942)

Present Law

The Tax Reform Act of 1969 in effect required private nonoperating foundations to make payouts at a specified minimum level, generally either (1) as direct expenditures to accomplish charitable purposes, or (2) as grants to public charities or private operating foundations. All administrative expenses incurred for such charitable purposes count as qualifying distributions. If certain requirements are met, a foundation may count as current distributions amounts "set aside" to be paid within five years for a specific project.

As enacted in 1969, the payout provision had required foundations to make qualifying distributions equal to the higher of (1) the foundation's net income (other than long-term capital gains) or (2) the foundation's minimum investment return—then set at six percent of the fair market value of the foundation's investment assets, with that rate subject to certain adjustments for post-1970 years. The Tax Reform Act of 1976 substituted a flat five-percent rate for measuring the minimum investment return. In 1981, the Economic Recovery Tax Act (ERTA) repealed the prior-law rule that had required foundations to distribute any excess of net income over the minimum investment return. Thus, to avoid excise tax under present law, a private nonoperating foundation must make qualifying distributions, by the end of the following year, at least equal to five percent of the fair market value of its investment assets for the year, less the amount of section 4940 tax on the foundation's net investment income for the year.

The payout rules under section 4942 do not apply to private operating foundations. However, to qualify for operating status, a private foundation must meet certain payout requirements.[5]

Reasons for Change

The committee believes that a reasonable limitation should be placed on the extent to which grant administrative expenses may be counted in satisfaction of the payout requirement, in order to ensure that more foundation expenditures actually reach charitable beneficiaries.

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[5] See note 1, *supra*.

Explanation of Provisions

Grant administrative expenses

Under the bill, the amount of grant administrative expenses paid during a taxable year which may be taken into account as qualifying distributions may not exceed the excess (if any) of (1) 15 percent of the aggregate amount of qualified grants made by the foundation during the year and the immediately preceding four taxable years, over (2) the aggregate amount of grant administrative expenses paid during the four preceding taxable years which were taken into account as qualifying distributions.

The 15-percent limitation applies to administrative expenses (such as wages) which are allocable to the making by the foundation of any contribution, gift, or grant which is a qualifying distribution. If a payment by a foundation is a contribution, gift, or grant which is a qualifying distribution, then all administrative expenses allocable to the payment are grant administrative expenses. A set-aside which is made for purposes of making a contribution, gift, or grant constitutes a contribution, gift, or grant in the taxable year in which treated as a qualifying distribution, and administrative expenses allocable to such a set-aside are grant administrative expenses.

The 15-percent limitation does not apply with respect to administrative expenses incurred by a foundation directly for the active conduct of its exempt activities.[6] For example, if one activity of a private foundation is to provide direct assistance to other charities in conducting their own programs and in their fund raising, the salary of the foundation's employee who does such work at the other charity for a period of time does not constitute a grant administrative expense.[7] Administrative expenses which, without respect to the 15-percent limitation, may not be counted as qualifying distributions (e.g., administrative expenses incurred in the production of investment income) do not enter into the computation of the 15-percent limitation.

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[6] For purposes of the definition of operating foundations under section 4942(j), all administrative expenses (such as staff salaries and traveling expenses) necessary to conduct a foundation's exempt activities, regardless of whether they are directly for the active conduct of such exempt activities, are treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are reasonable in amount (Treas. Reg. sec. 53.4942(b)-1(b)(1)). This allocation rule does not apply for purposes of the 15-percent limitation.

[7] The following illustrates the application of these rules. Assume that X Foundation is a private nonoperating foundation whose principal purpose is to relieve poverty and human suffering. The Foundation has a salaried staff of employees located in various areas of the country. Three-fourths of the Foundation's expenditures consist of grants to charitable organizations; the remaining one-fourth is for operation of a soup kitchen and other direct delivery services (e.g., the furnishing of temporary shelter).

The administrative expenses incurred by the X Foundation in its grantmaking activities are considered grant administrative expenses. The administrative expenses associated with operation of the soup kitchen and other direct delivery services performed by the Foundation are not considered grant administrative expenses for purposes of this provision. That is, the expenses of the direct providing by the Foundation through its employees of food and shelter to individuals through operation of the soup kitchen and the shelter are treated as incurred directly for the active conduct of the Foundation's exempt activities, rather than as expenses allocable to contributions of food and shelter.

Under a transitional rule, the amount of grant administrative expenses in any base period year which began before January 1, 1984 will be treated as constituting no more than 15 percent of the foundation's qualified grants in that year. For example, if during 1982 the actual grant administrative expenses of a calendar-year foundation amounted to 25 percent of qualified grants, the computation of the limitation for 1984 would assume that the percentage for 1982 was only 15 percent.

The 15-percent limitation applies with respect to the section 4942 payout rules and does not affect other foundation tax rules applicable to payments of expenses by a private foundation. Thus, the payment of excessive compensation to a foundation manager would constitute an act of self-dealing under section 4941(d) and a taxable expenditure under section 4945(d)(5), whether or not such expenses caused the 15-percent limitation to be exceeded. On the other hand, the mere fact that a foundation's grant administrative expenses exceeded the 15-percent limitation would not itself establish that any of such expenses constitute, for example, taxable expenditures under section 4945(d)(5).

Technical amendment

In ERTA, section 4942 was amended to define the required minimum payout as five percent of the value of the foundation's net investment assets (rather than the higher of that figure or net income). The ERTA amendment failed to add back to the newly defined payout amount the previously applicable modifications set forth in section 4942(f)(2)(C), relating to (i) repayments to the foundation of amounts previously treated as qualifying distributions (e.g., scholarship loans); (ii) amounts received on disposition of assets previously treated as qualifying distributions; and (iii) amounts previously set aside for a charitable project but not so used.

The bill adds to the required minimum payout the amounts specified in Code section 4942(f)(2)(C) (certain loan repayments, proceeds from asset dispositions, and unused set-asides).

Effective Date

The amendments made by section 305 of the bill apply to taxable years beginning after December 31, 1983.

E. Abatement of First-Tier Excise Taxes in Certain Cases (Sec. 306 of the bill and Code secs. 4942-4945)

Present Law

First-tier sanctions

Under present law, any violation of the foundation rules (secs. 4941-4945) results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). For example, a violation of the prohibitions on self-dealing transactions or jeopardizing investments triggers an excise tax equal to five percent of the amount involved in the self-dealing transaction (sec. 4941) or the jeopardizing investment (sec. 4944), payable for each year (or part thereof) in the taxable period. This means that the tax under section 4941 or 4944 continues to be imposed each year beginning when the prohibited act occurs and ending only when the Internal Revenue Service issues a deficiency notice or assesses tax on the act, or when the prohibited act is "corrected."

In general, the first-tier excise tax on the foundation (or on the disqualified person engaged in self-dealing) applies automatically when a foundation rule is violated. However, where a foundation fails to satisfy the section 4942 payout requirements solely as a result of an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period.

If there is a violation of the prohibitions on jeopardizing investments, taxable expenditures, or self-dealing, an initial excise tax is imposed on any foundation officer, director, trustee, or responsible employee who knowingly participated in the prohibited act, unless the manager had reasonable cause to excuse participation in the act. This first-level tax on the manager cannot exceed $5,000 ($10,000 in the case of self-dealing) for any one such violation.

Second-tier sanctions

If a violation of the foundation rules (secs. 4941-4945) is not "corrected" within a specified period, an additional excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person). For example, a second-tier tax equal to 200 percent of the amount involved in a self-dealing transaction would be imposed on the disqualified person unless (1) the prohibited transaction is undone to the extent possible and (2) the foundation is placed in a financial position not worse than it would be had the disqualified person dealt with the foundation under the highest fiduciary standards.

Similarly, an additional excise tax is imposed on a foundation manager who refuses to agree to correct a violation of the prohibitions on self-dealing, jeopardizing investments, or taxable expenditures. The second-tier tax on the manager cannot exceed $10,000 for any one such violation.

Additional penalties

If a foundation rule violation is willful and flagrant,[8] or if there has been a prior violation of any foundation rule, the excise tax sanctions are doubled, unless the violation was due to reasonable cause (sec. 6684). In addition, a termination tax (sec. 507) may be imposed on the foundation if the violation was willful and flagrant or there have been "willful repeated" [9] violations.

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[8] An act or failure to act violating a foundation rule is deemed willful and flagrant if it is "voluntarily, consciously, and knowingly" committed in violation of any said rule and if it "appears to a reasonable man to be a gross violation ***" (Treas. Reg. sec. 1.507-1(c)(2)). No motive to avoid the foundation restrictions is necessary to make an act or failure to act willful. However, an act or failure to act is not willful if the foundation (or a manager, if applicable) does not know that it is an act to which the foundation rules apply (Treas. Reg. sec. 1.507-1(c)(5)).

[9] For this purpose, the term willful repeated violations means at least two acts or failures to act both of which are "voluntary, conscious, and intentional" (Treas. Reg. sec. 1.507-1(c)(1)).

Reasons for Change

The committee believes that the present-law automatic first-tier penalties are stricter than necessary to enforce the foundation requirements in certain circumstances. Therefore, in those instances where it can be shown that there was reasonable cause for the violation (other than self-dealing) and there was no willful neglect of the rules, the Internal Revenue Service should have discretionary authority to relieve the foundation from the first-tier penalty tax, provided that the foundation corrects the violation. The committee finds no justification for extending such an abatement mechanism to acts of self-dealing, particularly since the penalty tax for such violations is payable by the self-dealer, not by the foundation, and since under current law commercial transactions between disqualified persons and foundations are generally prohibited.

Explanation of Provision

The bill provides discretionary authority to the Internal Revenue Service to abate first-tier chapter 42 private foundation taxes, other than the section 4941 tax on self-dealing, if it is established to the satisfaction of the Service that the violation of the foundation rules (1) was due to reasonable cause and not to willful neglect and (2) has been corrected within the appropriate correction period. A violation which was due to ignorance of the law is not to qualify for such abatement.

Effective Date

The amendments made by section 306 of the bill apply to taxable events occurring after December 31, 1983.

F. Amendment to Voter Registration Rules (Sec. 307(a) of the bill and Code sec. 4945(f))

Present Law

Under present law, an excise tax is imposed on private foundation expenditures for nonexempt purposes, including expenditures for political activities (sec. 4945). Expenditures paid or incurred by a foundation to influence the outcome of any specific election or to carry on, directly or indirectly, voter registration activities generally are taxable expenditures (sec. 4945(d)(2)).

However, current law provides an exception for amounts paid to, or incurred by, certain organizations that are engaged in nonpartisan voter registration activities if the following requirements are met (sec. 4945(f))—

(1) The organization must be described in section 501(c)(3) and exempt from income tax under section 501(a);

(2) The voter registration activities must be nonpartisan, must not be confined to one specific election period, and must be carried on in at least five States;

(3) The organization must spend at least 85 percent of its income directly for the active conduct of activities constituting the purpose for which it is organized and operated;

(4) The organization must receive at least 85 percent of its total support (other than gross investment income) from other exempt organizations, the general public, governmental units, or any combination of these sources. However, the organization may not receive more than 25 percent of such support from a single exempt organization, nor may it receive more than 50 percent of its support from investment income; and

(5) Contributions to the organization for voter registration activities must not be subject to conditions that they be used only in specified States, political subdivisions, or other areas of specified States, or that they may be used only in one specific election period.

Reasons for Change

Present law is intended both to encourage private foundation support for certain nonpartisan voter registration activities, and to preclude private foundations from engaging in narrowly limited activities which are designed to favor particular candidates and which are partisan in nature. The committee believes that elimination of the "five State rule," while retaining all other requirements under current law, is consistent with these objectives. In addition, the committee notes that any donee organization which may engage in foundation-supported voter registration activities must be tax-exempt under section 501(c)(3), and therefore is prohibited from engaging in partisan activities.

Explanation of Provision

The bill repeals the requirement that a private foundation may support a voter registration drive only if the drive is conducted in at least five States, but retains all other requirements of present law (sec. 4945(f)). Thus, as under present law, the activities of the organization conducting the voter registration drive must be nonpartisan, and cannot be confined to one specific election period, and contributions to the organization for voter registration drives may not be limited to use in specified States, or political subdivisions or other areas thereof, or in one specific election period.

Effective Date

The amendment made by section 307(a) of the bill takes effect on January 1, 1984.

G. Definition of Family Member (Sec. 307(b) of the bill and Code sec. 4946(d))

Present Law

The tax rules applicable to private foundations in effect prohibit certain transactions or holdings involving a disqualified person and a private foundation. Under present law, the term disqualified person includes substantial contributors to a foundation, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities. The disqualified family members are the individual's spouse, ancestors, and all lineal descendants (and their spouses) (sec. 4946(d)).

Reasons for Change

The committee believes that, weighing the difficulties of keeping track in perpetuity of all lineal descendants of a disqualified person against the need to preserve the integrity of the foundation rules, it is appropriate to include only children, grandchildren, and great-grandchildren (and their spouses) in lineal descendants who are disqualified persons by reason of being members of a disqualified person's family.

Explanation of Provision

The bill provides that lineal descendants of a disqualified person who are considered members of the family of that individual, and as such, disqualified persons, are the individual's children, grandchildren, and great-grandchildren, and the spouses of such descendants.

Effective Date

The amendment made by section 307(b) takes effect on January 1, 1984.

H. Public Disclosure and Accessibility of Information on Foundations to Grant Applicants (Sec. 307(c) of the bill and Code sec. 6104(d))

Present Law

Annual returns

A private foundation must file an annual information return (Form 990-PF) with the Internal Revenue Service and furnish a copy of the return to the Attorney General (or other official) in the relevant State (sec. 6033).

The Form 990-PF includes the following information for the taxable year: gross income and related expenses, disbursements, a balance sheet showing assets, liabilities, and net worth, total contributions and gifts received, the names and addresses of all substantial contributors, the names and addresses of the foundation managers and highly compensated employees, and the compensation and other amounts paid to the foundation managers and highly compensated employees. Also, the return currently requests certain information regarding applications for grants from the foundation (name, address, and telephone number of the person to whom applications should be addressed; any required format, information, and materials; deadlines for submitting applications; and any limitations on the types of awards that the foundation makes, such as by geographical areas, charitable fields, kinds of donee institutions, etc.).

The failure to file a timely exempt organization information return (unless reasonable cause is shown) results in a sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the organization (sec. 6652(d)). Failure to file a return after a reasonable demand by the Internal Revenue Service (unless reasonable cause is shown) results in an additional sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the exempt organization officer or employee who fails to file the information return.

Disclosure requirements

Under present law, all information required to be furnished on the private foundation annual return must be made available to the public by the Internal Revenue Service (sec. 6104).

In addition, a copy of the private foundation annual return must be made available, at the principal office of the foundation, to any citizen who requests to inspect the return within 180 days after a notice of availability has been published (sec. 6104(d)). This notification must be published in a newspaper with general circulation, in the county in which the foundation's principal office is located, not later than the due date for filing the return. The published notice must state the address of the private foundation's principal office and the name of its principal manager.

Finally, the Internal Revenue Service is required to notify the Attorney General (or other official) of the relevant State in the event of (1) denial of tax-exempt status to an organization, (2) the operation of a charitable organization in a manner that fails to meet the requirements for tax-exempt status, or (3) the mailing of a notice of deficiency regarding taxes imposed on private foundations (sec. 6104(c)). In addition, the Service is to make available to such State officials information about the preceding items that are relevant to any determination under State law.

Reasons for Change

The committee believes that the private foundation reporting and disclosure requirements provide valuable information both for public information purposes and for tax administration purposes. Because the General Accounting Office has concluded that the Internal Revenue Service has not fully been attentive to enforcing the annual return requirements relating to information primarily beneficial to the public, the committee believes that the Service should intensify its enforcement activities to ensure availability of this information.

Also, the committee believes that the required newspaper notice should include the foundation's telephone number, as an aid to grant applicants.

While the committee is aware of the various resources presently available to grant applicants, the general public may still experience difficulties in obtaining all information needed about foundation grantmaking. This problem would be alleviated if all private foundations provided the public with information in an accessible and understandable form, for example, through annual reports.

Explanation of Provision

The bill requires that the annual notice of availability of the private foundation annual return, which is required to be published in a newspaper, must contain the telephone number for the foundation's principal office.

Also, the committee directs the Internal Revenue Service to enforce fully the present law rules relating to private foundation annual information returns (Form 990-PF), including the imposition, in appropriate cases, of penalties for failure to file a (complete) return where the return as filed fails to provide all required information. The committee also calls upon the Service to facilitate the flow of appropriate information to those State officials who are entitled to such information, and to coordinate more closely with the States to maximize the benefits to be derived from such information.

Effective Date

The amendment made by section 307(c) of the bill takes effect on January 1, 1984.

I. Amendments to Excess Business Holdings Rules (Secs. 308-311 and 315(b) of the bill and Code sec. 4943)

Present Law

General rules

In 1969, the Congress was concerned that managers of foundations which owned large holdings in a business tended to be relatively unconcerned about producing income to be used in charitable activities, that their attention and interest would be devoted to the operation, maintenance, and improvement of the business while neglecting exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, the Congress concluded that a private foundation should be limited in the amount of a business which it may control.

The Tax Reform Act of 1969, in effect, generally limited the combined ownership of a business corporation by a private foundation and disqualified persons (for this purpose, including certain related foundations) to not more than 20 percent of the voting stock.[10] (For example, if the disqualified person's holdings are five percent, the foundation itself may hold only 15 percent.) If persons other than disqualified persons have effective control of the corporation, the combined foundation/disqualified person holdings are limited to 35 percent. A private foundation may not conduct any business as a proprietorship.

Under a de minimis rule, there are no excess business holdings if a private foundation (together with related foundations) owns not more than two percent of the voting stock and not more than two percent of the value of all classes of stock, regardless of the extent of ownership by disqualified persons. Also, there are no percentage limitations on foundation ownership of a business which is functionally related to the foundation's charitable programs, or of a business deriving 95 percent of its gross income from certain passive sources.

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[10] If all disqualified persons together do not own more than 20 percent of the voting stock of a corporation, there is no limit on the nonvoting stock which may be held by the private foundation. To determine permitted holdings in a partnership, the foundation's "profits interest" is aggregated with the profits interests of all disqualified persons and substituted for the voting stock limitation applicable to corporations, and "capital interest" is used in place of nonvoting stock. In computing the holdings of any business enterprise, stock or other interests owned, directly or indirectly, by a corporation, partnership, estate, or trust are considered as owned proportionately by the beneficial owners.

Holdings in excess of permitted limits which are acquired after May 26, 1969 other than by purchase (e.g., by gift or bequest) must be disposed of by the foundation within five years after acquisition (sec. 4943(c)(6)). Post-May 26, 1969 purchases of stock by a foundation or a disqualified person which create or increase aggregate holdings beyond permitted limits do not qualify for the five-year grace period, and may immediately result in excise tax penalties on the foundation (subject to a 90-day grace period for a foundation to reduce its holdings as required after purchases by a disqualified person).

Grandfathered holdings

The 1969 Act provided special rules applicable where the business holdings of a private foundation (combined with disqualified persons) exceeded the 20-percent/35-percent limitation on May 26, 1969. These special rules also apply to holdings acquired under trusts irrevocable on that date, or certain wills executed by that date, even though the actual transfer to the foundation occurs later. In general, grandfathered holdings are permitted to be retained, but are subject to gradual reduction over several phases.

Under the first phase, by the deadlines shown below the combined foundation/disqualified person holdings cannot exceed 50 percent of the voting stock of the corporation or, if less, 50 percent of the value of all outstanding shares—

Ownership on 5/26/69:	*Deadline to reach 50% combined holdings:*
More than 95% by foundation alone.	May 26, 1989
More than 75% combined holdings.	May 26, 1984
More than 50% combined holdings.	May 26, 1979

After expiration of the first phase, a second set of divestiture requirements becomes operational—

(1) If disqualified persons do *not* own more than two percent of the corporate voting stock at any time during the second phase (the 15 years after the close of the first phase), the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (i.e., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and if at any time after the end of the second phase the holdings of disqualified persons exceed two percent, then the foundation itself cannot hold more than 25 percent of the voting stock.

(2) If the holdings of disqualified persons exceed two percent at any time during the second phase, then at all times thereafter the combined foundation/disqualified person holdings are limited to 50 percent, with no more than 25 percent of the voting stock being held by the foundation.

Grandfathered holdings are subject to reduction by operation of the "downward ratchet" rule. The rule, in effect, provides that if there is any reduction in the holdings of a private foundation or in combined private foundation/disqualified person holdings, then these holdings can never go up again to the former grandfathered or otherwise permitted level over 20 percent (35 percent, if applicable).

Reasons for Change

After review of the general limitations on business holdings by foundations, the committee believes that the same reasons for which in 1969 the Congress prohibited private foundations from owning substantial holdings of a business enterprise continue to be valid today. The committee continues to believe that the attention and energies of private foundations should be directed toward performance of their exempt functions and not toward the operation of a business enterprise. The committee believes that without such restrictions, the energies and resources of the private foundation may well be directed toward the operation of the business enterprise. Where the charitable ownership predominates, the business also may be run in a way which unfairly competes with other businesses. Moreover, ownership of significant interests in business enterprises makes the provisions relating to self-dealing, minimum payout, and taxable expenditures difficult to administer.

In addition, the committee believes that the 1969 Act rules requiring divestiture of pre-1969 holdings by private foundations continue to be appropriate for several reasons. First, the same reasons for prohibiting private foundations from acquiring significant interests in business enterprises after 1969 apply to pre-1969 holdings. Second, since the enactment of the 1969 Act, many private foundations have divested themselves of their excess business holdings in reliance on the mandates of the 1969 Act. The committee believes that it would be unfair to those private foundations who properly relied on and complied with the law to permit those private foundations who have failed to comply with the 1969 Act rules to now become exempt from divestiture.

After reviewing the 1969 Act rules, the committee also has concluded that certain modifications to those rules are desirable in order to carry out the overall intent of the 1969 Act.

First, the committee believes that the rules which require divestiture within five years of excess business holdings acquired by a private foundation after 1969 other than by purchase may not provide sufficient time to dispose of holdings which are exceptionally large or complex. Accordingly, the bill provides the Internal Revenue Service with discretionary authority to extend the normal five-year divestiture period for an additional five years in appropriate cases involving an unusually large gift or bequest of diverse or complex business holdings.

Second, the committee believes that the operation of the "downward ratchet" rule is too harsh in certain situations. For example, since the enactment of the 1969 Act, it is now possible for a business enterprise to adopt an employee stock ownership plan (ESOP) to which the stock of the enterprise is contributed for the benefit of its employees. Often this stock is later redeemed from the ESOP as those employees terminate their employment. Under the downward ratchet rule, the private foundation's relative holdings decrease when the stock is transferred to the plan; as a result, when the stock is redeemed from the plan, the private foundation is forced to sell some of its otherwise permitted holdings to reduce its relative holdings to the new lower limit. The committee believes that the downward ratchet rule should not apply where the reductions in the relative holdings of the private foundation result from new issuances of stock so long as the reduction is relatively minor. Accordingly, the bill provides an exception to the downward ratchet rule where the reduction of the relative holdings of the private foundation are reduced by less than two percent by reason of changes in the number of outstanding shares.

Finally, the committee believes that three modifications to the rules governing pre-1969 holdings are appropriate. First, under the 1969 Act divestiture rules for grandfathered holdings, the 10-year and 15-year periods for the first phase are determined by reference to the combined holdings of the private foundation and disqualified persons, while the 20-year period is determined by reference only to the holdings of the private foundation. The committee does not find any reason for this different basis for measuring the length of the first phase. Accordingly, the bill provides that the 20-year period also is to be determined by reference to the combined holdings of the private foundation and disqualified persons.

Second, during the second and third phases of the divestiture rules for pre-1969 holdings, private foundations have a lower limit (i.e., 25 percent of voting stock) for direct holdings if disqualified persons own more than two percent of the business enterprise. Where disqualified persons first acquire more than two percent during those phases, the present statute does not permit any time for the private foundation to reduce its holdings to the lower limit and avoid excise taxes. Accordingly, the bill provides that in such circumstances, the private foundation has five years to reduce its holdings to the lower limit.

Finally, the committee bill makes a technical correction to the 1969 Act to allow the Herndon Foundation to continue to hold a majority interest in certain business holdings.

A number of concerns were brought to the attention of the committee relating to technical issues under certain provisions of the excess business holdings rules with respect to which final regulations have not yet been issued. It is the committee's understanding that final regulations relating to these reserved issues will provide that, except in certain abuse cases, there will be no constructive ownership through active business corporations, a passive parent corporation of an affiliated group of active business corporations will be treated as an active business corporation, stock received in a corporate reorganization or other readjustment will be treated as the stock surrendered in the reorganization or readjustment to the extent there is no increase in either the percentage ownership of the foundation or the percentage ownership of the foundation and its disqualified persons in combination, and any excess stock received in a corporate reorganization or other readjustment will be treated as acquired other than by purchase. Based on this understanding, the committee does not believe any statutory changes are required with respect to reserved issues under the excess business holdings regulations.

Explanation of Provisions

Disposition of certain post-1969 gifts or bequests

The bill gives the Internal Revenue Service discretionary authority to grant an extension of an additional five years to dispose of certain business holdings acquired by a private foundation after 1969 by gift or bequest. This provision applies only in the case of an unusually large gift or bequest of either diverse business holdings or holdings with complex corporate structures.

To be eligible for the extension, the private foundation must submit a plan to the Service for disposition of the business holdings which can reasonably be expected to be carried out before the end of the extension period.[11] Before the Service can grant the extension, the foundation must establish that disposition within the initial five-year period was not possible (except at a price substantially below fair market value[12]) because of the size and complexity or diversity of the business holdings, and that the foundation has made diligent efforts to dispose of those business holdings within the initial five-year period.

This provision of the bill applies to business holdings as to which the initial five-year period (sec. 4943(c)(6)) ends after the date of enactment.

Exception to downward ratchet rule

The bill provides an exception to the downward ratchet rule under which decreases in the percentage holdings of a private foundation are disregarded if (1) the decreases are due solely to the issuance of stock (or to issuance of stock coupled with subsequent redemptions of stock) of the business enterprise, (2) the net percentage decrease does not exceed two percent, and (3) the number of shares held by the private foundation is not affected by the issuance of stock or any redemption of stock which was coupled to the issuance of stock.[13]

If the exception applies, the limits on the maximum permitted holdings of the private foundation and on the maximum permitted combined foundation/disqualified person holdings will not be reduced by the amount of the net decrease. If the net percentage decrease exceeds two percent, the exception does not apply, and, as under present law, the limit on the maximum holdings of the private foundation is permanently reduced by the amount of the decrease.

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[11] The plan must also be submitted to the Attorney General of the relevant State for his or her consideration, and the Internal Revenue Service is to consider any comments which the Attorney General may make as to the plan.

[12] For purposes of this provision in sec. 308 of the bill, a price which is at least five percent below fair market value is to be considered a price which is substantially below fair market value.

[13] For purposes of this provision in section 309 of the bill, an increase in the number of shares held by the foundation which results solely from a stock split applicable to all holders of the same class of stock is to be disregarded.

This amendment is effective for decreases and subsequent increases occurring after the date of enactment.

Eligibility for 20-year first phase

The bill modifies the divestiture rules of present law to provide that the 20-year first phase period to reduce pre-1969 excess business holdings applies if the combined holdings of the private foundation and disqualified persons exceeded 95 percent on May 26, 1969. This amendment is effective on the date of enactment.

Modification of second and third phases

The bill provides that if a private foundation's maximum business holdings must be reduced to 25 percent of the voting stock by reason of the acquisition by disqualified persons of more than two percent of the business enterprise during either the second or third phase of the divestiture rules, the private foundation is given five years to dispose of the excess over 25 percent. This five-year period cannot be extended pursuant to the provision of the bill (sec. 308) relating to the divestiture period for certain post-1969 gifts or bequests. This amendment applies to acquisitions made after the date of enactment.

Technical correction in description of Herndon Foundation

The bill makes a technical correction to clarify that the Herndon Foundation is permitted to continue to hold a majority of the stock of certain business enterprises. This amendment applies as if included in section 101(*l*)(4) of the Tax Reform Act of 1969.

J. Exemption for Certain Games of Chance (Sec. 312 of the bill and Code sec. 513)

Present Law

Under present law, organizations that are exempt from Federal income taxation are subject to tax on income derived from an unrelated trade or business (secs. 511-514). The term unrelated trade or business generally means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the activities for which the organization was granted tax exemption.

Present law includes an exception to the definition of an unrelated trade or business for certain bingo games conducted by tax-exempt organizations (sec. 513(f)).

Reasons for Change

The committee believes that, under certain circumstances, tax-exempt organizations should not be subject to the tax on unrelated business taxable income on income from games of chance which may legally be conducted under State law only by nonprofit organizations.

Explanation of Provision

The bill provides that the term unrelated trade or business does not include any trade or business that consists of conducting any game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization.

Effective Date

The provision applies retroactively to games of chance conducted after June 30, 1981, in taxable years ending after that date.

K. Exception to Self-Dealing Rules for Certain Stock Transactions (Sec. 313 of the bill and Code sec. 4941)

Present Law

The Tax Reform Act of 1969 in effect prohibited certain transactions between a private foundation and disqualified persons (including substantial contributors), and imposed excise taxes for violations of these rules. The transactions prohibited as "self-dealing" generally include (1) the sale, exchange, or leasing of property between a private foundation and a disqualified person and (2) the lending of money or other extension of credit between a private foundation and a disqualified person (sec. 4941).

Reasons for Change

Under present law, once a contributor to a foundation is treated as a substantial contributor, that person retains status as a disqualified person forever, regardless of the relative value of the person's contributions (sec. 507(d)). As indicated in the description below of section 314 of the bill, the committee believes that this rule should be changed so that the disqualified person status of a person whose relative contributions have become insignificant will terminate in appropriate cases.

In general, the committee believes that this change should apply prospectively. However, it has come to the attention of the committee that the rule that substantial contributors retain their status as disqualified persons forever has resulted in the application of the self-dealing rules in a case involving the sale of publicly traded stock of Murphy Motor Freight Lines, Inc. (the "Company") by the Wasie Foundation to the Company. In that case, the Company was treated as a disqualified person because of contributions of less than $10,000 early in the life of the Wasie Foundation. As a result, the sale of stock by the Wasie Foundation to the Company pursuant to the settlement of a court case involving the control of the Company was treated as an act of self-dealing. The committee believes that this transaction should not be subject to section 4941 taxes so long as the total consideration paid to the Wasie Foundation (i.e., the amount of any cash and the fair market value of any notes received for the stock by the Wasie Foundation in connection with such purchase) was equal to or exceeded the value of the stock at the time of the sale.

Explanation of Provision

The bill provides that Code section 4941 is not to apply to the purchase during 1978 of stock from a private foundation (and to any note issued in connection with such purchase) if (1) consideration for the purchase equaled or exceeded the fair market value of the stock; (2) the purchaser of the stock did not make any contribution to the foundation at any time during the five-year period ending on the date of the purchase; (3) the aggregate contributions to the foundation by the purchaser before such date were less than $10,000 and less then two percent of the total contributions received by the foundation as of that date; and (4) the purchase was pursuant to the settlement of litigation involving the purchaser. That is, under the bill Code section 4941 is not to apply in the case of the 1978 sale of stock of the Murphy Motor Freight Lines, Inc. by the Wasie Foundation to the Murphy Motor Freight Lines, Inc. and the related financing by the Wasie Foundation if the total consideration received (i.e., the sum of the cash and the value of the notes) equaled or exceeded the fair market value of the stock to Wasie Foundation.

Effective Date

The provision applies retroactively for 1978 and subsequent years. In addition, section 313 of the bill provides for a refund or credit of any section 4941 taxes previously paid if claim for refund or credit is filed within one year from the date of enactment.

L. Termination of Status as Substantial Contributor (Sec. 314 of the bill and Code sec. 507(d))

Present Law

Under present law, status as a disqualified person is relevant for several private foundation provisions, including the prohibitions on self-dealing between a disqualified person and the foundation and on excess business holdings. The term disqualified person generally includes substantial contributors, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities (sec. 4946).

The term substantial contributor means a person whose contributions to the foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the contribution is made, but only if the person's contributions exceed $5,000 (sec. 507(d)(2)). Once a person becomes a substantial contributor, that person retains that status forever.

Reasons for Change

The committee believes that the rule under which persons retain their status as substantial contributors forever is unnecessarily restrictive and may lead to unintended harsh consequences in certain circumstances. The committee believes that an individual may sufficiently terminate connection with and control over a private foundation, so that he or she no longer should be treated as a disqualified person, if there has been a sufficiently long time since that person had made any contribution to or had any relationship with the foundation, and if there have been much larger contributions from another person to the foundation. This often may be the case where a person makes relatively small contributions near the date of creation of the foundation and an unrelated person makes a substantially larger contribution later.

Explanation of Provision

The bill provides that a person will not continue to be treated as a substantial contributor as of the close of a taxable year of a foundation if three requirements are met.

First, neither the person nor any related person[14] made a contribution to the foundation at any time within the 10-year period ending at the close of the taxable year. Second, at no time during the 10-year period was that person or any related person a foundation manager of the private foundation. Third, the aggregate contributions (adjusted for the growth of the contributions in the foundation) made by such person and related persons are determined by the Internal Revenue Service to be insignificant when compared to the aggregate amount of contributions to that foundation by one other person. The committee intends that such contributions generally are to be considered insignificant if they are less than one percent of the contributions by the other person (adjusted for growth).[15]

Effective Date

The amendment made by section 314 applies to taxable years beginning after December 31, 1983.

M. Review of Treasury Regulations on Expenditure Responsibility (Code sec. 4945)

Present Law

In the case of grants to organizations other than public charities, a private foundation must exercise "expenditure responsibility" over the grant (sec. 4945(d)). To ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants.

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[14] For purposes of this provision, the term related person means any other person who would be a disqualified person (within the meaning of sec. 4946) by reason of his or her relationship to the substantial contributor. In the case of a contributor which is a corporation, the term also includes any officer or director of the corporation.

[15] For example, a gift of $250,000 in cash in 1969 would be considered insignificant in comparison to a gift of $100 million made by another person in 1979. Similarly, a gift of $250,000 of stock in 1969 would be considered insignificant in comparison to a gift of $107 million in 1979, even assuming the value of the stock (originally worth $250,000 when made) had appreciated in value to $1.2 million as of the date on which the $107 million gift was made. However, a gift of $250,000 of stock in 1969 which had appreciated in value to $15 million would not be considered insignificant in comparison to another's gift of $107 million in 1979.

Treasury regulations expressly state that the expenditure responsibility rules do not make donor foundations insurers or guarantors of the activities of donee organizations, and set forth guidelines under which donor foundations may satisfy the section 4945 rules (Reg. sec. 53.4945-5(b)). For example, the regulations state that a private foundation considering a grant request should conduct a limited inquiry concerning the potential donee, complete enough to give a reasonable person assurance that the grant would be used for charitable purposes. The scope of the inquiry would vary with factors such as the dollar amount of the grant. No such pre-grant inquiry would be required if the donee organization had received prior grants from the donor foundation and had submitted to the donor the required reports substantiating proper use of the earlier grant funds.

The donor foundation must obtain a written commitment from the donee foundation that the latter will use the grant funds solely for charitable purposes and will submit reports as to whether the funds have been used in compliance with the grant terms. The grantor foundation need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability (Reg. sec. 53.4945-5(c)(1)). In meeting its own reporting requirements to the Internal Revenue Service, the grantor foundation may rely on statements from the donee organization or other records showing the information which the grantor, in turn, must report to the Service (Reg. sec. 53.4945-5(c)(4)).

Reasons for Committee Action

The committee reaffirms the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for exempt purposes. At the same time, the committee is concerned whether implementation of the statutory requirements in Treasury regulations may have added unduly burdensome or unnecessary requirements in some respects, which may operate to deter grants by some foundations to newly formed, community-based organizations.

Committee Action

The committee directed the Treasury Department to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. As part of its review, Treasury is to modify the required grantor reports to the Internal Revenue Service. The Treasury Department is to report to the committee on its review and modifications.

N. Review of Treasury Regulations on Reliance on IRS Classifications

Present Law

Private foundations must exercise expenditure responsibility with respect to grants made to another private foundation (sec.

4945(d)). In addition, distributions to a private nonoperating foundation generally may not be used to satisfy the grantor foundation's minimum distribution requirements (sec. 4942). Therefore, in order to avoid violations of the expenditure responsibility and minimum distribution rules, a private foundation must determine whether a potential donee is a private foundation or public charity.

In many cases, the public charity status of a donee is determined by the percentage of its support that is received from the general public. The Internal Revenue Service issues determination letters to all section 501(c)(3) organizations relating to their status as public charities or private foundations. For new organizations without four years of support history, advance rulings are issued based on a determination of whether the charity can reasonably be expected to meet the public support test during an advance ruling period of either two or five years.

In general, a donor is permitted to rely on a determination by the Internal Revenue Service of a donee's public charity status until publication of notice of a change of status. However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-(3)(c)).

To facilitate reliance on published classifications, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization.[16] In addition, the Service has published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported.[17]

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[16] Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-1 C.B. 620). In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax penalties for failure to exercise expenditure responsibility).

[17] Under these guidelines, a grant generally will be considered unusual where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-1 C.B. 621).

Reasons for Committee Action

While the committee believes that it is appropriate for a private foundation to inquire whether its grant will cause the donee to lose public charity status, the committee is concerned that private foundations may hesitate to make grants to new organizations that may have little support from the general public in the first two or three years of their existence, because it is difficult for the foundation to obtain assurance that the grant will not cause the organization to fail to qualify for public charity status.

Committee Action

The committee directed the Treasury Department to extend the advance ruling period during which qualifying new organizations are considered public charities to five years, and to amend its regulations to permit greater reliance on Internal Revenue Service classifications concerning new organizations in the first five years of their existence.

O. Revenue Effect

The provisions of title III of the bill will reduce fiscal year budget receipts by $13 million in 1984, $45 million in 1985, $46 million in 1986, $47 million in 1987, and $50 million in 1988.

TITLE IV—TAX SIMPLIFICATION PROVISIONS

A. Estimated Income Tax (secs. 411-414 of the bill, sec. 6654 of the Code, and Revenue Ruling 83-111)

Present Law

Under present law, an individual who fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty at the rate established for interest (under sec. 6621). The penalty may not be waived. The penalty is computed by applying the interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. Estimated tax payments of the alternative minimum tax are not required.

There are four exceptions to the general underpayment penalty. No penalty is imposed upon a taxpayer if total tax payments for the year (withholding plus estimated tax payments) equal or exceed an installment based on (1) the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year; (2) 80 percent of the taxes which would be due if the income already received during the current year were placed on annual basis; (3) 90 percent of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) the tax computed by using the facts shown on the prior year's return under the current year's tax rates and exemptions. Also, no penalty is imposed where the tax (reduced by withholding) is less than a minimal amount ($300 in 1983, $400 in 1984, and $500 in 1985 and thereafter), or where there was no tax liability for the preceding taxable year.

Reasons for Change

The committee believes that generally taxpayers who pay their tax by making estimated tax payments should, to the extent possible, be treated no more favorably than those who pay their tax primarily through wage withholding. While the present rules governing the estimated tax work well in most cases, there are technical problems and inequities that should be corrected. First, the committee is concerned that the Commissioner of Internal Revenue cannot waive the penalty for failure to make estimated tax payment even where the failure is due to extreme hardship. While the committee recognizes that the system cannot be administered if waivers are readily available, the Commissioner should have the authority to grant a waiver in limited extreme hardship cases.

Therefore, the bill authorizes the Internal Revenue Service to waive the penalty in certain limited circumstances.

In addition, the present law exceptions to the penalty may, on the one hand, allow individuals to improperly avoid estimated tax requirements in some circumstances, while subjecting other individuals to a substantial penalty for failure to meet one of the exceptions by a few dollars. The exceptions are therefore restructured to avoid these results. Finally, the committee believes that persons subject to the alternative minimum tax, as restructured under TEFRA, should be required to make current estimated payments just as individuals subject to other income taxes are required to do.

Explanation of Provision

Estimated income tax for individuals

The bill makes a number of modifications to the present law requirements and consolidates all the rules into one section of the Code. Under the bill, the underpayment penalty with respect to any installment will apply to the difference between payments made by the due date of the installment and the lesser of an installment based on 80 percent of the tax shown on the return or 100 percent of the tax shown on the preceding year's return, if a return was filed for the preceding year. In addition, a penalty will be imposed with respect to any payment only to the extent the total payments for the year up to the required installment are below 80 percent of the taxes which would be due if the income already received during the current year was placed on an annualized basis.[1] The exceptions from the penalty described in paragraphs (3) and (4) of present law (above) are repealed. Estimated tax payments for the alternative minimum tax will be required.

The Internal Revenue Service can waive the penalty if the failure to make a payment was due to casualty, disaster, or other unusual circumstances where it would be inequitable to impose the penalty. Thus, for example, this waiver could be granted where the taxpayer's books and records were destroyed by fire or other casualty, or where payment was not made because of the death or serious illness of the taxpayer. Also, the penalty can be waived where it would be inequitable to impose a penalty, for example, because the taxpayer substantially overstated his or her tax liability shown on the return.

Credit of tax overpayments

The bill also provides that the rules relating to the crediting of an income tax (individual or corporate) overpayment against an estimated tax liability shall be determined without regard to Revenue Ruling 83-111.[2] That ruling held that where a taxpayer with an overpayment of tax from a prior year files a timely return pursuant to an extension of time to file, the crediting of the overpayment to the current year's estimated tax liability may not be made prior to the date the return is filed and the taxpayer so elects.

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[1] Subsequent installments must be adjusted to recapture any reduction resulting from the application of this rule.

[2] I.R.B. 1983-31, p. 6.

Under the bill, it is intended that the taxpayer may elect to credit the overpayment to an estimated tax payment arising after the overpayment arose but before the election is made. Where the credit is made to an estimated tax payment arising prior to the election, interest on any overpayment will cease to run as of the effective date of the credit (and interest on any underpayment which arises because of a deficiency in tax for the prior year will run from that date).

Thus, for example, assume a taxpayer makes estimated tax payments (including withholding) of $10,000 in 1984 and receives an extension of time to file the 1984 return until August 15, 1985. Also assume that a return is filed on August 15, 1985, showing a liability of $8,000 for 1984. The taxpayer may elect to credit the $2,000 overpayment to the April 15 estimated tax payment of his or her 1985 tax. Interest on the $2,000 overpayment will not be payable. If it is later determined that the taxpayer's liability for 1984 was actually $11,000, interest on an underpayment of $3,000 will begin to run on April 15, 1985.

Effective Date

The provisions will be effective for taxable years beginning after December 31, 1983.

Revenue Effect

The repeal of the "90 percent" and "this year's tax rates" exceptions from the penalty will increase budget receipts by $105 million in fiscal year 1984, will not have an effect in fiscal year 1985, will increase by $4 million in fiscal year 1986, $9 million in fiscal year 1987, and $11 million in fiscal year 1988.

The provision measuring the penalty from last year's return will reduce budget receipts by $40 million a year beginning in fiscal year 1985.

The provision allowing a waiver of the penalty will reduce budget receipts by less than $5 million annually.

The provision relating to the alternative minimum tax will increase fiscal year budget receipts by $557 million in 1984, $54 million in 1985, $45 million in 1986, $49 million in 1987, and $52 million in 1988.

B. Domestic Relations

1. Treatment of Transfer of Property Between Spouses or Incident to Divorce (sec. 422 of the bill and sec. 1041 of the Code)

Present Law

The Supreme Court has ruled that a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims results in the recognition of gain to the transferor *(United States* v. *Davis* (370 U.S. 65 (1962)). The spouse receiving the property receives a basis in the asset transferred equal to its fair market value. These rules do not apply in the case of the equal division of community property, and the IRS has ruled that this rule does not apply to the partition of jointly held property.[3] The tax treatment of divisions of property between spouses involving other various types of ownership under the different State laws is often unclear and has resulted in much litigation.[4] Several states have amended their property law in an attempt to avoid the result in the *Davis* case.

In addition, under present law, losses are not allowed with respect to the transfer of property between spouses (sec. 267), and capital gains treatment and installment sales reporting are not allowed on the sale or exchange of depreciable property between spouses (secs. 1239 and 453(g)). These limitations do not apply to transfers between former spouses.

Reasons for Change

The committee believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit.

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggers recognition of gain.

Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the *Davis* rule to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.

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[3] See Rev. Rul. 74-347, 1974-2 C.B.26

[4] See e.g., *Commissioner* v. *Collins*, 412 F.2d 211 (10th Cir. 1969); *U.S.* v. *Wallace*, 439 F. 2d 757 (8th Cir. 1971); *Commissioner* v. *Wiles*, 499 F.2d 255 (10th Cir. 1974); *U.S.* v. *Imel*, 523 F.2d 853 (10th Cir. 1975); *W. W. McKinney*, 64 T.C. 262 (1975); *U.S.* v. *Bosch*, 590 F.2d 165 (5th Cir. 1979).

The committee believes that to correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed.

Explanation of Provision

The bill provides that the transfer of property to a spouse incident to a divorce will be treated, for income tax purposes, in the same manner as a gift. Gain (including recapture income) or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis (whether the property has appreciated or depreciated in value). A transfer will be treated as incident to a divorce if the transfer occurs within one year after the parties cease to be married or is related to the divorce. This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged. Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

In addition, this nonrecognition rule applies in the case of transfers of property between spouses during marriage.

Where an annuity is transferred, or a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract (under sec. 72), or the usual treatment as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the annuity payments or payments by the trust qualify as alimony or otherwise discharge a support obligation.[5] The transfer of a life insurance contract to a spouse incident to a divorce or separation generally will no longer result in the proceeds of the policy later being includible in income, since the policy will have a carryover basis and therefore the transfer for value rules (sec. 101(a)(2)) will not apply. Also, the transfer of an installment obligation will not trigger gain.

Effective Date

The provision applies to transfers after the date of enactment of the bill. However, it will not apply to transfers pursuant to instruments in effect before such date unless the parties elect to have these provisions apply.

Revenue Effect

This provision will reduce budget receipts by less than $5 million annually.

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[5] This rule relates, in part, to amendments made to Code section 71 by section 423 of the bill.

2. Alimony (sec. 423 of the bill and secs. 71 and 215 of the Code)

Present Law

In general

Under present law, payments of alimony pursuant to a decree of divorce or separate maintenance, a written separation agreement or decree for support or maintenance are deductible by the payor spouse and includible in the income of the recipient spouse. The amount of the payment is deductible in computing adjusted gross income and thus is allowable whether or not the payor itemizes his or her deductions.

In order to be treated as alimony, a payment must meet several requirements. First, the payment must be in discharge of a legal obligation imposed upon or incurred by a spouse because of a family or marital relationship. Second, the payment must be imposed under the decree of divorce or separate maintenance or under a written instrument incident to the divorce or separation, made under a written separation agreement, or required under a decree of support or maintenance. Third, the payment must be "periodic." A payment will not qualify as "periodic" if it discharges a principal sum, unless the sum may be paid over a period exceeding 10 years from the date of the divorce or separation decree, instrument or agreement; then the annual amount treated as alimony cannot exceed 10 percent of the principal sum. A contingent payment is not a payment in discharge of a principal sum.

Payments which are fixed by the decree or agreement as child support are not treated as alimony and therefore are not deductible by the payor or includible in income of the recipient.[6]

Legislative background

Prior to 1942, there was no statutory provision explicitly dealing with alimony payments. In 1917, the Supreme Court held that, under the provisions of the Income Tax Act of 1913, alimony paid to a divorced wife was not taxable income.[7] From 1917 to 1942, the result in the *Gould* case remained unchanged and alimony was neither includible in the recipient's income nor deductible by the payor.

When tax rates were increased significantly in 1942, Congress recognized that the higher tax rates would intensify the hardship of payment of alimony out of after-tax income. Congress, therefore, enacted provisions in the Revenue Act of 1942 to require that certain alimony payments be included in the recipient spouse's income and to permit the payor spouse to deduct those payments as an itemized deduction. These provisions applied to alimony payments made by persons who were divorced or legally separated. In 1954, the alimony provisions were extended to apply to payments made under a decree for support where the parties are physically separated. The Tax Reform Act of 1976 permitted alimony to be deducted in arriving at adjusted gross income so that a taxpayer who does not itemize deductions may nevertheless deduct alimony.

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[6] *Commissioner* v. *Lester*, 366 U.S. 299 (1961) sets forth rules relating to the designation of amounts as child support rather than alimony.

[7] *Gould* v. *Gould*, 245 U.S. 151 (1917).

Tax effects

A principal purpose for the present tax treatment of alimony is to relieve the payor of the burden of paying tax on the income which is transferred to the payee spouse as alimony and to impose that burden on the spouse receiving the alimony. In addition to transferring the tax burden, under present law an overall tax savings generally results because the payor is normally in a higher marginal tax bracket than the payee. Because rates for a single taxpayer or head of household are lower than the rates for married persons filing separate returns (upon which the joint return rates are based), two individuals who are divorced and between whom alimony is paid may pay less total tax than they paid prior to marriage or during marriage.

For example, assume that single individuals A and B have earned income of $51,000 and $11,000 (taxable income of $50,000 and $10,000), respectively. As single taxpayers, their respective taxes for 1983 would be $14,738 and $1,121. Their combined tax is $15,859. If A and B were married for 1983, their joint return tax liability would be $15,574.[8] If A and B are divorced for 1983 and A pays B $20,000 alimony, they each would have a liability as a single taxpayer of $6,477. Their combined tax would be $12,954.

Reasons for Change

The committee believes that the present law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS. The committee believes that a uniform Federal standard should be set forth to determine what constitutes alimony for Federal tax purposes. This will make it easier for the Internal Revenue Service, the parties to a divorce, and the courts to apply the rules to the facts in any particular case and should lead to less litigation. The committee bill attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump-sum property settlements.

Explanation of Provision

Under the bill, alimony payments will continue to be deductible by the payor spouse and includible in income by the recipient spouse.[9] However, the bill amends the definition of alimony. The requirement that the payment must be made on account of a marital obligation imposed under local law will be repealed and the present law requirement that the payment be "periodic" will not be retained.

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[8] This is based on $58,900 taxable income ($62,000 gross income, $1,100 marriage penalty deduction (under sec. 221) and a $2,000 deduction for personal exemptions. This example assumes neither party itemizes deductions.

[9] The bill does not affect the present law rules concerning the ability of a deceased spouse's estate to deduct alimony payments.

Under the bill, an alimony payment must meet several requirements. The payment must be made in cash and be received by, or on behalf of, the payor spouse (or former spouse). A payment can also qualify as alimony, for example, where a cash payment is made to a third party for the benefit of the payee spouse. As under present law, an alimony payment must be made under a decree of divorce or separate maintenance or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or maintenance payments.

Where the parties are divorced or legally separated, they may not be members of the same household at the time the payment is made. The parties are not to be treated as members of the same household where the taxpayer is preparing to shortly depart from the household of the other spouse.

In order to prevent the deduction of amounts which are in effect transfers of property unrelated to the support needs of the recipient, the bill provides that a payment qualifies as alimony only if the payor (or any person making a payment on behalf of the payor) has no liability to make any such payment for any period following the death of the payee spouse. A provision for a substitute payment, such as an additional amount to be paid as child support after the death of the payee spouse will prevent a corresponding amount of the payment to the payee spouse from qualifying as alimony. Amounts payable under a life insurance contract on the life of the payee spouse will not be treated as a liability which would affect the status of other payments made by the payor spouse.

The parties, by clearly designating in a written agreement, can provide that otherwise qualifying payments will not be treated as alimony for Federal income tax purposes and therefore will not be deductible or includible in income.

As under present law, amounts fixed as child support will not be treated as alimony.

The bill provides that the Internal Revenue Service may require the payor spouse to furnish on his or her tax return the name and social security number of the payee spouse, and that the payee must furnish that number to the payor. A $50 penalty can be assessed against any party for failure to comply with the applicable requirement.

In order to prevent a one-time property settlement from being disguised as alimony, the bill provides for the recapture of excess amounts which have been treated as alimony during the calendar year the payments began or the next succeeding calendar year. Under these rules if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payor to include the excess in income and allowing the payee who previously included the alimony in income a deduction for that amount in computing adjusted gross income. A similar rule applies to the extent the payments in the second year exceed the payments in the third year by more than $15,000. This rule is intended to prevent persons whose divorce occurs near the end of the year from making a deductible property settlement at the beginning of the next year. Recapture is not required if either party dies or if the payee spouse remarries by the end of the calendar year which is two years after the payments began. Also the rule does not apply to temporary support payments (described in sec. 71(b)(2)(C)) or to payments which fluctuate as a result of a continuing liability to pay, for at least three years, a fixed portion of income from the earnings of a business, property or services.

Thus, for example, if the payor makes alimony payments of $50,000 in the first year and no payments in the second or third year, $35,000 will be recaptured (assuming none of the exceptions apply). If instead the payments are $50,000 in the first year, $20,000 in the second year and nothing in the third year, the recapture amount will consist of $5,000 from the second year (the excess over $15,000) plus $27,500 for the first year (the excess of $50,000 over the sum of $15,000 plus $7,500). (The $7,500 is the average payments for years two and three after reducing the payments by the $5,000 recaptured from year two.)

Effective Date

These provisions will generally apply to divorce or support decrees and agreements executed after 1983. The provision will also apply with respect to the modification of a prior instrument where the modified instrument expressly so provides.

Revenue Effect

These provisions will reduce revenues by $8 million in fiscal year 1984, $46 million in fiscal year 1985, and $11 million in fiscal year 1986, and will increase revenues by $23 million in fiscal year 1987 and $39 million in fiscal year 1988.

3. Dependency Exemption (secs. 424 and 427 of the bill and secs. 151 and 152(e) of the Code)

Present Law

Under present law, a $1,000 deduction, for dependency exemption, is generally allowed for each dependent child of the taxpayer. Normally, in order to qualify as a taxpayer's dependent, a child must have over half of his or her support for the year furnished by the taxpayer. The child may not have gross income of $1,000 or more in the taxable year unless the child is under the age of 19 or is a student.

In the case of children of divorced or separated parents, a special rule applies in determining which parent provided over half of the support (sec. 152(e)).

In general, a divorced or separated parent who has custody of a child for the greater part of the year (the custodial parent) may claim the dependency exemption for the child if the parents together have custody of the child for more than one-half of the year and provide more than one-half of the child's support. A special rule provides that the noncustodial parent, rather than the custodial parent, may claim the dependency exemption if (1) a decree or written agreement allocates the exemption to the noncustodial parent and the noncustodial parent pays at least $600 for the support of the child during the calendar year; or (2) the noncustodial parent provides at least $1,200 for the support of the child during the calendar year and the custodial parent does not clearly establish that he or she provided more for the support of the child than did the noncustodial parent. None of these rules apply in the case where the dependency exemption has been allocated under the special rules applying to multiple support where no one person contributed over half the support of an individual.

In addition to the dependency exemption, the deduction for medical expenses, the treatment of a parent as qualifying for either single rates or head of household rates, the earned income credit, and the credit for household and dependent care services are, in part, determined by reference to whether the parent furnishes over half of the support of a child.

Reasons for Change

The present rules governing the allocations of the dependency exemption are often subjective and present difficult problems of proof and substantiation. The Internal Revenue Service becomes involved in many disputes between parents who both claim the dependency exemption based on providing support over the applicable thresholds. The cost to the parties and the Government to resolve these disputes is relatively high and the Government generally has little tax revenue at stake in the outcome. The committee wishes to provide more certainty by allowing the custodial spouse the exemption unless that spouse waives his or her right to claim the exemption. Thus, dependency disputes between parents will be resolved without the involvement of the Internal Revenue Service.

Explanation of Provision

Under the bill, as under present law, the parent having custody of a child for the greater portion of the year (the custodial parent) will generally be treated as having provided more than one-half of the child's support and therefore be entitled to the dependency exemption. This rule also will apply to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement. The bill provides three exceptions to the general rule. First, the custodial parent can release his or her claim to the exemption for the year to the noncustodial parent. For this exception to apply, the custodial parent will have to sign a written declaration that he or she will not claim the child as a dependent for the year, and the noncustodial parent will have to attach the written declaration to his or her tax return. That declaration may be made for one or more specified calendar years. The parties may make a permanent declaration a copy of which the noncustodial parent attaches to each year's return, or the declaration may be made by the custodial spouse annually in order to better insure the receipt of child support payments.

Next, as under present law, the general rule will not apply in the case of multiple support agreements. Finally, an exception is provided to continue existing law for certain decrees or agreements which are executed before January 1, 1984, and under which the custodial parent had agreed to release his or her claim to the dependency exemption to the noncustodial parent . Thus, if such an agreement exists, the noncustodial parent may claim the dependency exemption if he or she provides at least $600 for the support of the child during the year. The parties may modify the decree or agreement to make this rule inapplicable by expressly so providing.

The bill also provides that the support by the spouse of a remarried parent will be treated as support provided by that parent in applying these rules.

For purposes of the medical expense deduction, any child subject to the rules described above will be treated as a dependent of both parents. Thus, a parent can deduct medical expenses paid by that parent for the child even though a dependency exemption for the child may be allowed to the other parent.

Under the bill, certain provisions are amended to provide consistent rules among various inter-related sections concerning family status of individuals living apart. The basic rule adopted is that in the present child and dependent care credit (sec. 44A)). An amendment is made to section 143(b) to provide that for an otherwise married individual living with a child to be considered not married, his spouse may not be a member of the household for the last six months of the year, rather than the entire year as under present law. The definition of head of household status (sec. 2) is amended to provide that the household must be maintained as the principal place of abode for the child for more than one-half of the year, rather than for the entire year as under present law. Further, the definitions of marital and head of household status, the earned income credit (sec. 43), and the child and dependent care credit (sec. 44A) are amended to provide that any custodial parent who releases a claim to a dependency exemption under the above rules will be treated as entitled to the dependency exemption for the purposes of these sections. Thus, such a custodial parent could be eligible for unmarried status, head of household status, or the credits if the other conditions of those provisions are met.

Finally, the bill provides that the $1,000 dependency exemption is to be determined without regard to any income received by an individual who is permanently and totally disabled for services performed at a sheltered workshop school operated by a charity or government.

Effective Date

These provisions will be effective for taxable years beginning after December 31, 1983.

Revenue Effect

These provisions will have a negligible effect on budget receipts.

4. Innocent Spouse Relieved of Liability in Certain Cases (sec. 425 of the bill and secs. 66 and 6013 of the Code)

Present Law

Tax liability of spouses who file joint returns

In general, a husband and wife are permitted to file a joint income tax return, even if one spouse has no income or deductions. Spouses who file a joint return have joint and several liability for the tax computed on their aggregate income.

Under limited circumstances, a spouse may be relieved of liability for tax (including interest and penalties) on a joint return (sec. 6013(e)). The application of this so-called innocent spouse rule is limited to cases in which the liability for tax results from an omission from gross income that exceeds 25 percent of the gross income stated in the return. In such cases, the person seeking relief must establish that the unreported income is attributable to the other spouse, and that he or she had no knowledge of (or reason to know of) the omission. The determination of the spouse to whom the unreported income is attributable is made without regard to community property laws. In addition, taking into account whether the innocent spouse significantly benefitted from the omission from income, a determination is required as to whether it would be inequitable to hold such spouse liable for the tax. In determining whether there was an omission of more than 25 percent of the income disclosed on the return, amounts as to which adequate information was provided on the return are not taken into account.

Community income of spouses who live apart

In general, if a husband and wife file separate returns, each is required to report one-half of the income attributable to community property under State law. However, if certain requirements are met, relief from tax liability is provided for an abandoned spouse (sec. 66). To qualify, a couple must be married at some time during the calendar year, but live apart during the entire calendar year. The spouse seeking relief must not have filed a joint return, and one or both of the spouses must have earned income (*i.e.*, income attributable to the performance of personal services) that constitutes community income. In addition, no portion of the earned income (other than *de minimis* amounts) may have been transferred (directly or indirectly) between the spouses before the close of the calendar year.

If all of the above requirements are met, the applicable community property law with respect to certain types of income will be disregarded for Federal income tax purposes. Under special allocation rules (1) earned income (other than income from a trade or business or a partner's distributive share of a partnership's income) is treated as the income of the spouse who rendered the personal services, (2) income derived from a trade or business (other than that carried on by a partnership) is treated as the income of the spouse who carries on the trade or business, unless the other spouse exercises substantially all of the management and control of such trade or business, and (3) a partner's distributive share of a partnership's income is treated as the income of the partner. All other community income is characterized in accordance with the applicable community property laws.

Reasons for Change

The committee believes that the present law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, for example, where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered.

Also there may be situations in community property states when it is inequitable to tax a spouse filing a separate return on earnings of the other spouse where the innocent spouse received no benefit from the earnings.

Explanation of Provision

The bill liberalizes the innocent spouse joint return relief provision by expanding the circumstances in which the relief may be granted. The bill also provides additional relief to a spouse who is liable for tax on community income that is attributable to the other spouse.

Joint return liability of innocent spouse

Under the bill, the innocent spouse (sec. 6013(e)) rule will apply to cases in which the tax liability results from a substantial understatement of tax that is attributable to grossly erroneous items (including claims for deductions or credits, as well as omitted income) of the other spouse. Grossly erroneous items include any item of income that is omitted from gross income, regardless of the basis for omission. A claim for deduction or credit will be treated as a grossly erroneous item only if the claim had no basis in law or fact. The bill defines a substantial understatement as any understatement of tax that exceeds $500. As under present law, relief may be granted only where it would be inequitable to hold the innocent spouse liable.

In applying these rules, community property laws will continue to be disregarded in determining to whom an item is attributable. The bill does not specifically require that the determination of whether it would be inequitable to hold the innocent spouse liable include the consideration of whether such spouse benefitted from the erroneous item, but that factor should continue to be taken into account. The omission from income determination may apply notwithstanding that adequate information about the erroneous items was provided on the return.

Relief for separate return liability attributable to community income

The bill provides a new rule relating to the treatment of certain community income. This provision applies in cases where a spouse fails to include in gross income an item of community income that would be treated as the income of the other spouse if the special allocation rules applicable under the community-income provision of present law had applied. This rule will apply only where the spouse seeking relief does not file a joint return for the taxable year, and establishes that, at the time the return was filed (if a return is filed), he or she had no knowledge of (or reason to know of) the item of community income. The bill also requires that a determination be made that it would be inequitable to include the unreported income in the gross income of the spouse seeking relief. This determination may take into account whether the spouse benefitted from the untaxed income and whether the defense was promptly raised so as to prevent the period of limitations from running on the other spouse.

If all of the above requirements are met, then the unreported community income will be included in the gross income of the spouse to whom the income is attributable under the special rules of allocation.

Effective Date

The bill will apply to all taxable years to which the Internal Revenue Code of 1954 applies. Further, the bill provides that corresponding provisions will be deemed to be included in the Internal Revenue Code of 1939, and will apply to all taxable years to which the 1939 Code applied. The effective date provided in the bill is not intended to open a year that has been closed by the statute of limitations, res judicata, or otherwise.

Revenue Effect

This provision will have a negligible revenue effect on budget receipts.

5. Estate Tax Treatment of Certain Property Settlements (sec. 426 of the bill and sec. 2043 of the Code)

Present Law

Under present law, transfers of property (other than certain terminable interests) between spouses are not subject to estate or gift taxes.

With several exceptions, transfers of property to a former spouse in satisfaction of marital or property rights are taxable gifts. A transfer of property between former spouses is not subject to gift tax if the transfer is pursuant to a written agreement entered into not more than two years prior to divorce and is in settlement of marital or property rights or to provide a reasonable allowance for the support of minor children (sec. 2516). In addition, property transfers ordered by a divorce court having the power to order the disposition of the property are not taxable gifts.[10] Finally, the transfer of property in discharge of a former spouse's right to support is not a taxable gift.

For estate tax purposes, a claim of a former spouse based on the release of marital or property rights is not deductible in computing the taxable estate unless the claim is based on a court decree where the court had the power to determine the marital or property rights of the spouse.[11]

Reasons for Change

The committee believes that the estate tax treatment of transfers made in settlement of marital or property rights should be conformed to the gift tax treatment. This will allow the parties to rely on a written agreement even though the payor spouse dies before the agreement is completely executed.

Explanation of Provision

The bill allows an estate tax deduction for transfers pursuant to claims arising under a written agreement in settlement of marital or property rights where the agreement would have qualified those transfers as non-taxable for gift tax purposes (under sec. 2516). Thus, where the transferor dies prior to completing the transfers under the written agreement, no estate tax will be imposed with respect to the property transferred by the estate.

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[10] *Harris* v. *Comm'r.*, 340 U.S. 106 (1950).

[11] Id.

Effective Date

This provision will apply in the case of decedents dying after the date of enactment of the bill.

Revenue Effect

The provision will have a negligible effect budget receipts.

C. Revision of At-Risk Rules (secs. 431 and 432 of the bill and secs. 46, 48 and 465 of the Code)

Present Law

Loss limitation rules

Present law (sec. 465) provides an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate leasing transactions.[12] The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity.

Under the loss limitation at-risk rules, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity. The initial amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged security for repayment. This amount is generally increased by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity.

A taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans), (2) the lender has an interest (other than as a creditor) in the activity, or (3) the lender is a related party to the taxpayer. In the case of activities other than investments in motion picture films or video tapes, farms, oil and gas property, geothermal property, or leased personal property (generally, the areas covered by the original 1976 at-risk rules), the interested party and related party rules apply only to the extent established by Treasury regulations. The taxpayer is also not considered at risk with respect to amounts for which the taxpayer is protected against loss by guarantees, stop-loss arrangements, insurance (other than casualty insurance) or similar arrangements. Losses which may not be deducted for any taxable year because of the loss limitation at-risk rule may be deducted in any subsequent year in which the rule does not prevent the deduction.

The loss limitation at-risk rule is applicable to individuals and to closely held corporations more than 50 percent of the stock in which was owned, at any time during the last half of the taxable year, by or for 5 or fewer individuals.[13] Stock ownership is generally determined according to the rules applicable for purposes of identifying a personal holding company (sec. 542(a)(2)). In the case of a partnership or S corporation, the rules apply at the partner or shareholder level.[14]

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[12] The Tax Reform Act of 1976, P.L. 94-455, applied the at-risk rule to four specific activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of personal property; and (4) exploring for, or exploiting, oil and natural gas resources. The Revenue Act of 1978, P.L. 95-600, extended the rule to all activities except real estate and certain equipment leasing engaged in by closely held corporations.

[13] The at-risk rule was extended to closely held corporations in 1978.

The loss limitation at-risk rules are applied on an activity-wide basis. Present law provides that a taxpayer's activity with respect to any individual film, farm, oil and gas property, geothermal property, or leased personal property is treated as a separate activity. Thus, a taxpayer may deduct losses from an oil and gas property, for example, only to the extent he is at risk with respect to that specific property.[15] With respect to other types of investment, activities are treated as one activity (i.e., aggregated) if the activities constitute a trade or business and the taxpayer actively participates in the management of that trade or business (in the case of partnerships or S corporations, if 65 percent or more of losses is allocable to persons who actively participate in the management of the trade or business). A taxpayer may thus deduct losses from these activities based on the extent of his at-risk investment in an entire actively managed trade or business.

Investment tax credit rules

The Economic Recovery Tax Act of 1981 provided that the allowance of the investment tax credit is subject to an at-risk limitation. The limitation applies to the same activities and the same category of taxpayers that are subject to the at-risk loss limitation rules. Thus, the investment credit at-risk rules applies to individuals and closely held corporations that are engaged in a trade or business or other income-producing activity (other than real estate and certain corporate leasing).

Under the investment tax credit at-risk rules, the credit is not allowed for amounts invested in qualifying property to the extent the invested amounts are not at risk within the meaning of the loss limitation provisions (sec. 465(b)). Amounts generally are not considered at risk if (1) the amount was borrowed and the taxpayer is not personally liable for repayment of the debt (nonrecourse debt), (2) the lender has an interest (other than a creditor) in the business activity in which the property is used, (3) the lender is a related party to the taxpayer, or (4) the taxpayer is protected against the loss of the invested amount.

Present law provides two exceptions to the investment credit at-risk rules. Under the first exception, amounts borrowed (other than convertible debt) with respect to qualifying investment tax credit property no later than the taxable year the property is placed in service are generally considered at risk if (1) the taxpayer at all times has a minimum 20-percent at-risk investment in the property (determined without regard to the exception) and (2) the amount borrowed is owed to either a qualified lender or a Federal, State, or local government, or is guaranteed by a Federal, State or local government. Qualified lenders include banks, savings and loan institutions, credit unions, insurance companies, qualified pension trusts, and other persons actively and regularly engaged in the business of lending money.

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[14] These provisions no longer apply at the corporate level as a result of an amendment made by the Subchapter S Revision Act of 1982 (P.L. 97-354).

[15] Present law allows aggregation, under certain conditions, of films, farms, and leasing and oil and gas properties owned by a partnership or S corporation.

For the qualified lender exception to apply, the lender must not be related to the taxpayer. The qualified lender may also not be a person who receives a fee with respect to the taxpayer's investment in the qualifying property (e.g., a promoter) or a person related to such person. The exception also does not apply if the taxpayer has acquired the property from (1) the qualified lender (or a person related to the lender) or (2) a person related to the taxpayer.

Present law also applies a safe harbor exception for certain level payment loans related to qualified energy property.

In the case of a partnership or S corporation, the investment credit at-risk rule applies at the partner or shareholder level. Thus, the calculation of amounts at-risk is made by each partner or shareholder to whom the at-risk rules apply. Amounts for which a partnership or S corporation are considered at risk under the qualified lender exception are allocated among the partners or shareholders according to the rules for allocation of the investment tax credit. However, this allocation rule does not apply for purposes of determining whether each partner or shareholder has a minimum 20-percent at-risk investment in the property. Thus, to benefit from the qualified lender exception, each partner or shareholder must have an individual 20-percent at-risk investment in the property, determined under the general rule (i.e., the partner or shareholder must contribute cash or be personally liable for borrowed funds in this amount).

The at-risk limitation on the investment tax credit applies to property placed in service on or after February 19, 1981. An exception is provided for property placed in service on or after that date if the property was acquired by the taxpayer under a binding contract entered into before February 19, 1981.

Credit pass-through leases

Present law (sec. 48(d)) allows a lessor of new investment tax credit property to elect to transfer ("pass through") the credit to the lessee, subject to certain conditions. For certain short-term leases, only a portion of the credit may be transferred.

The present law at-risk rules do not specifically indicate how the rules apply in the case of a pass-through lease. Some lessees have apparently taken the position that the rules do not apply to a lessee, thus effectively rendering the rules inapplicable to certain lease transactions. These lessees appear to have claimed the credit although the lessee (and in some cases, the lessor) has little or no at-risk investment in the property.

Legislative background

The loss limitation at-risk rule was first adopted by Congress in 1976, and later expanded in 1978, in order to limit the incentives for taxpayers to reduce their tax liability by investing in tax shelter activities in which they were not subject to real economic risk. The investment tax credit at-risk rule was adopted for similar reasons in 1981.

In general, the at-risk rules limit a taxpayer's tax benefits from an activity to those benefits attributable to funds which the taxpayer has personally invested in an activity (in the case of the loss limitation rule) or a property (in the case of the investment tax credit rule), including funds which the taxpayer borrowed and is personally liable to repay. In the case of property which is seller-financed (or financed by a party related to the seller), this reduces the incentive for the parties to inflate the purchase price in order to give the purchaser additional tax deductions (for depreciation or accrued interest) or an inflated investment tax credit. In these situations, the buyer may otherwise be unconcerned about the higher price, since the property may simply be repossessed by the seller after the buyer has benefited from the inflated deductions or credits. The at-risk rules also prevent tax benefits from accruing to a purchaser who has no real equity in a property because the property's value is, or may become, less than the face amount of a nonrecourse loan on the property. In these situations, the purchaser may be receiving tax benefits without bearing the economic burden of any corresponding decline in the property's value. In addition, the at-risk rules reduce the situations in which taxpayers may fail to "recapture" income or credits from the disposition of tax shelter property since, under the at-risk rules, the deductions would not originally have been allowed.

Reasons for Change

The committee is concerned that the investment tax credit at-risk rules contained in ERTA have generated significant confusion among taxpayers and inhibited certain non-tax shelter transactions. It appears that the interdependence of the loss limitation at-risk rules (which are applied on an activity-wide basis) and the investment tax credit rule (which must be applied on a property-by-property basis) is largely responsible for this confusion. By fashioning an independent rule for the investment tax credit, and adjusting the application of the qualified lender rule, the committee believes it has created a workable and fair new provision. In order to avoid any inequities which may result from application of the ERTA rules, the committee has made the new provisions applicable (at the taxpayer's election) as if included in ERTA.

With regard to the pass-through of the investment tax credit to a lessee, the committee is concerned that taxpayers have taken positions effectively avoiding the application of the at-risk rules to tax shelter lease transactions. To prevent persons from taking these positions, the bill specifically applies the at-risk rule to the lessee based on the minimum rent for which the lessee is personally liable under the lease. This is consistent with the general principle that a credit (or deduction) should be allowed only where a taxpayer bears a real economic risk.

The committee believes that the at-risk rules generally (including the loss limitation and investment tax credit at-risk rules) should continue to apply in those situations where tax shelter possibilities (i.e., overvaluation of assets or transfer of tax benefits to a party with no real equity in the property) present themselves. However, where non-recourse financing constitutes bona fide financing in which the debtor has a real equity interest in the property and is likely to make all payments for the property, and where repossession is unlikely, these tax shelter elements are not present and the at-risk rules are not needed. The bill identifies these situations by excluding from the at-risk rules active closely held corporate businesses, subject to certain minimum activity requirements. This change will eliminate the competitive disadvantage encountered by certain closely held businesses which have been prevented from utilizing legitimate nonrecourse financing (or recourse financing by active subsidiaries) by the at-risk rules.

In addition to the changes above, the committee's bill makes certain adjustments regarding the aggregation of activities for at-risk purposes and borrowing from related parties, consistent with the underlying policy of the at-risk rules.

Explanation of Provision

Revision of investment tax credit at-risk rules

Under the bill, the investment tax credit at-risk rules are revised. Instead of applying the loss limitation (sec. 465) at-risk rules directly, the bill reduces the credit base for the investment tax credit by the amount of nonrecourse financing, other than certain commercial financing, with respect to a property. However, the general concepts of the at-risk rules will continue to apply.

Under the bill, the basis (or cost, in the case of used property) of property for purposes of determining the investment tax credit is to be reduced by the amount of nonrecourse financing (other than qualified commercial financing) with respect to the property. The provision applies to the same taxpayers and the same activities that are currently subject to the at-risk rules. Nonrecourse financing includes amounts with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar agreements. Except to the extent otherwise provided by regulations, nonrecourse financing also includes amounts borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or a person related to such person (other than the taxpayer).

The bill provides an exception for qualified commercial financing similar to that under present law. Qualified commercial financing includes financing (other than convertible debt) provided or guaranteed by any Federal, State or local government, or borrowed from a qualified person. Qualified persons include any person actively and regularly engaged in the business of lending money. However, qualified persons do not include (1) any person related to the taxpayer, (2) any person from which the taxpayer acquired the property (or a person related to such person), or (3) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person). For these purposes, the bill adopts the definition of related person contained in section 168(e)(4) (relating to accelerated cost recovery). Under this rule, related persons generally include family members, fiduciaries and corporations or partnerships in which a person has at least a 10-percent interest.

In order for the exception for qualified commercial financing to apply, the amount of nonrecourse financing with respect to the property cannot exceed 80 percent of the credit base. Additionally, the exception does not apply where property was acquired by the taxpayer from a related person.

The present law safe harbor rule for certain energy property is continued under the bill.

The bill provides that, in the case of partnerships or S corporations, the determination of whether financing is nonqualified nonrecourse financing is to be made at the partner or shareholder level. However, a special rule is provided for financing provided by a qualified person to an S corporation. Under this rule, an allocable share of such financing is treated as recourse to an S shareholder if the financing is recourse at the corporate level and is provided with respect to qualified business property. Such financing will therefore not count as nonqualified nonrecourse financing and will not reduce the credit base, regardless of whether the shareholder is personally liable for repayment. Qualified business property includes property used by the S corporation in an active trade or business which during the entire 12-month period ending on the last day of the taxable year has at least three full-time non-owner employees (as defined for purposes at the exemption for active closely held businesses) substantially all of whose services are directly related to the business. One full-time employee must also be involved in the active management of the business. Qualified property does not include master sound recordings or other tangible or intangible assets associated with literary, artistic or musical properties. The amount of any partner's or shareholder's allocable share of any financing will be determined according to the rules for allocation of the investment tax credit.

The bill also includes rules for the treatment of subsequent increases and decreases in nonqualified nonrecourse financing. These provisions are generally consistent with the treatment of changes in the at-risk amount under present law.

Credit pass-through leases

The bill provides specific at-risk rules applicable to credit pass-through leases. These rules apply to the same types of taxpayers and the same activities as the at-risk rules generally.

Under the pass-through at-risk rules, the lessee initially is allowed the full investment tax credit only if the lessee is at risk for (i.e., is obligated to make) rental payments the present value of which is equal to at least 30 percent of the the lessee acquisition amount (18 percent in the case of 3-year property). The lessee acquisition amount is the amount for which the lessee is treated as having acquired the property under the general pass-through rules (i.e., without regard to the amount at risk). In addition, the amount of the lessee's credit cannot exceed the amount of the credit which would have been allowed to the lessor had the lessor's basis in the property been the lessee acquisition amount and had the lessor not made the pass-through election. Thus, the lessee will receive the full credit only if the lessor is at risk with respect to the property (assuming the lessor is a taxpayer subject to the at-risk rules).

For purposes of the pass-through rules, the lessee is considered to be at risk with respect to rental payments which the lessee is required to make under the lease in all events, and for which the lessee is not protected against loss through guarantees, stop-loss arrangements, or other similar arrangements. The present value of at-risk rental payments is to be determined by discounting all future minimum required payments by the rate in effect (as of the time the lease is entered into) for determining interest on underpayments of tax (sec. 6621).

Where the lessee is at risk for rental payments the present value of which is less than 30 percent of the lessee acquisition amount (18 percent in the case of 3-year property), the lessee is allowed only a portion of the credit. The portion of the full credit allowed for any taxable year is that portion equal to the ratio of (1) the aggregate rental payments actually made during the taxable year to (2) the lessee acquisition amount. The full remaining amount of the credit is allowed in the first year in which the lessee has made aggregate rental payments equal to 30 percent or more of the lessee acquisition amount. For example, a lessee who makes rental payments equal to 10 percent of the lessee acquisition amount in each of years 1 and 2 (and who is not otherwise at risk for rental payments equal to at least 30 percent of the lessee acquisition amount) will be allowed one-tenth of the credit in each of those years. If the lessee makes a further 10 percent payment in year 3 (resulting in aggregate payments of 30 percent of the lessee acquisition amount), the lessee will be allowed the full remaining amount of the credit. (In the case of 3-year property, the percentage is 18 rather than 30 percent.)

The bill provides that, for purposes of applying the lessee at-risk rules to partnerships and S corporations, rules similar to those in effect under the general investment tax credit at-risk rules shall apply (i.e., the partners and shareholders must individually be at risk for their share of the minimum lease payments). Additionally, the treatment of subsequent reductions in the lessee's at-risk amount (e.g., by entering into guarantees or stop-loss arrangements with respect to future rental payments) are to be based on the principles applied under the general rule (sec. 47(d)). For purposes of the recapture rule, where the lessee actually made a rental payment, the determination of the lessee's at-risk amount is to be determined as if he were still at risk to make that payment.

The bill provides the Treasury Department with authority to prescribe regulations necessary to carry out the purposes of the lessee at-risk rules. Specifically, the Treasury is provided with authority to prescribe regulations providing appropriate adjustments to required rental payments where the lessor bears expenses connected with the lease which a lessee normally would bear,[16] and specifying the extent to which contingencies in the lease will be disregarded for at-risk purposes. It is expected that these regulations will take into account the normal business practices associated with lease transactions, such as forgiveness of rental payments where the property is destroyed or damaged. The option of the lessee to unilaterally terminate a lease is not a contingency to be disregarded for at-risk purposes. However, the regulations may provide that if termination of a lease is permitted upon payment of a fixed amount, the lessee is to be considered at-risk for the lesser of the present value of the fixed amount or the present value of future rental payments that would be due after the date on which the lease could be terminated. The lessee's right to substitute other leased property in the future (e.g., a newer model of a leased computer) is a contingency which may be disregarded if the minimum rental payments under the lease are not reduced upon such substitution.

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[16] No inference is intended that the Treasury would not have this authority without specific statutory authorization.

Exclusion for active closely held businesses

Under the bill, certain active businesses conducted by closely held subchapter C corporations are exempted from the at-risk rules, both the loss limitation and investment tax credit at-risk rules. (Non-closely held corporations are exempt from at risk under present law.) The exemption does not apply to personal holding companies (as defined in sec. 542(a)), foreign personal holding companies (as defined in sec. 552(a)) or personal service corporations (as defined in sec. 269A(b)(1), using a 5-percent shareholder test). Additionally, the exemption does not apply to (1) equipment leasing businesses[17] or (2) any business involving the exploitation, sale, or lease of master sound recordings, motion picture films, video tapes or other literary, artistic or musical assets (except to the extent the taxpayer is completely at risk with respect to all amounts expended in connection with the acquisition or creation of a property used in the business). For this purpose, the provision of radio, television, cable television, or similar services pursuant to a license or franchise granted by the Federal Communications Commission or other Federal, State or local authority shall not be treated as an excluded business.

Under the bill, the exemption applies to active corporate businesses only if, during the entire 12-month period ending on the last date of the corporation's taxable year, the corporation had at least three full-time non-owner employees substantially all of whose services were directly related to such business. Also, at least one full-time employee of the corporation must perform services substantially all of which are in the active management of the business. In addition, the deductions for business expenses allowable to the corporation for the taxable year under sections 162 (relating to trade or business expenses) and 404 (relating to contributions to certain employee benefit plans) must exceed 15 percent of the gross income from the business.

For purposes of the 15-percent requirement, deductions for compensation for personal services rendered by a certain shareholder of the corporation, or a member of a shareholder's family, are excluded from the computation amount. In the case of a bank or other financial institution, gross income includes tax-exempt interest, and amounts paid to depositors as interest or dividends are treated as business expenses. The 15-percent test will not apply to a qualified life insurance company (i.e. a company which would be a life insurance company determined without regard to its unearned premiums).

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[17] Certain corporate equipment leasing businesses are presently exempt from the at-risk rules.

For purposes of the three-employee requirement, non-owner employees include any employee owning (directly or indirectly) less than 5 percent of the outstanding stock of the corporation. In the case of a partnership with corporate partners holding at least 50 percent of the profits interests, the taxpayer's interest in the partnership may qualify as an active trade or business. The three-employee test will be met if the number of employees of the partnership (or the taxpayer) in the business equals at least three times the number of corporate partners.

For purposes of the exemption for active closely held businesses, members of an affiliated group of corporations (sec. 1504(a)) are treated as a single taxpayer, except that a personal holding company, foreign personal holding company, or personal service corporation are not to be treated as members of the group. In determining whether a domestic corporation is a personal holding company for purposes of this rule, if the corporation holds an 80-percent owned foreign subsidiary which meets the active income requirements of section 954(b)(3)(A), the dividends from that foreign corporation shall be disregarded in determining personal holding company income and an active business of the subsidiary shall be attributed to its parent.

Aggregation of activities

For purposes of the loss limitation at-risk rule, the bill provides that a taxpayer's activities with respect to separate films or video tapes, farms, oil and gas properties, geothermal properties, or leased personal property are to be treated as one activity (i.e., aggregated) if the activities constitute all or part of a trade or business and the taxpayer actively participates in the management of each activity (in the case of partnership or S corporation, if 65 percent or more of losses for the taxable year are allocable to persons who actively participate in management of the activity.) This is similar to the rule applicable under present law to other forms of investment. However, for purposes of the covered activities, the taxpayer may aggregate activities only if the taxpayer actively participates in the management of each separate activity to be aggregated. For example, a taxpayer may treat two or more oil properties as one activity only if the taxpayer actively participates in the management of each individual property. Such a taxpayer would then be entitled to deduct losses from the oil properties based on the amount of at-risk investment (including undistributed profits) in the aggregated properties.

The determination of whether a person actively participates in the management of an activity depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the activity, actually performing services for the activity, or hiring and discharging employees. Factors which tend to indicate a lack of active participation include lack of involvement in management and operation of the activity, having authority only to discharge the manager of the activity, or having a manager of the activity who is an independent contractor rather than an employee.

Borrowing from related parties

The bill provides that recourse borrowing from related parties (including family members and entities controlled by the taxpayer) may be considered at risk for purposes of the loss limitation and investment tax credit at-risk rules. Recourse borrowing will be considered not at risk when the related party has an interest (other than as a creditor) in the activity or when the taxpayer is otherwise protected against loss. The bill also specifies that a corporation may be considered at risk with respect to amounts borrowed from its shareholders to finance participation in an activity.

Effective Date

The provisions applicable to the at-risk rules generally (including both the loss limitation and investment tax credit rules) will apply to taxable years beginning after December 31, 1983. The revision of the investment tax credit at-risk rules will apply to property placed in service after the date of enactment in taxable years ending after such date. However, at the election of the taxpayer, the investment tax credit provisions will apply as if included in the Economic Recovery Tax Act of 1981 (ERTA). Any such election will apply to all property of the taxpayer to which the ERTA rules applied.

Revenue Effect

This provision will have a negligible revenue effect.

D. Estate Tax Revisions

1. Permanent Rules for Reforming Governing Instruments Creating Charitable Remainder Trusts and Other Charitable Interests (sec. 441 of the bill and sec. 2055 of the Code)

Present Law

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part noncharitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In addition, a deduction is allowed for a remainder interest in a farm or personal residence. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Present law also allows the governing instruments of charitable split-interest trusts which where executed before December 31, 1979, to be amended to conform the governing instruments to the new requirements if the amendment is completed, or judicial proceedings necessary to amend the governing instrument are begun, by December 31, 1981.

Reasons for Change

Congress first permitted reformation of charitable remainder trusts in 1974 and since that time, the Congress has extended the period for reformations several times and extended the procedure to other types of split-interest charitable contributions. Even so, it has come to the attention of the committee that there are still many instruments providing for split-interest charitable contributions which do not meet the requirements for qualification under the rules of the Tax Reform Act of 1969. In many of these cases, disqualification results in reduced amounts passing to charity. In light of the repeated need to extend the period to reform such governing instruments and the fact that failure to meet the 1969 Act rules often results in reduced amounts passing to charity, the committee believes that a permanent rule permitting reformation of split-interest charitable contributions should be permitted so long as there are adequate safeguards to avoid abuse.

Specifically, the committee is concerned that governing instruments of charitable split-interest trusts which evidenced no attempt to comply with the 1969 Act rules would be reformed only when the defects are found upon audit by the Internal Revenue Service. In order to prevent this from occurring, the committee believes that, in order for a governing instrument of a charitable split-interest contribution to be reformable, either (1) the creator had to make a bona fide attempt to comply with the 1969 Act rules or (2) the taxpayer must initiate reformation proceedings before the Internal Revenue Service could reasonably be expected to begin audit. The committee believes that these rules will permit the correction of major, obvious defects (such as where the "income" interest is not expressed as an annuity interest or a unitrust interest) so long as the taxpayer initiates reformation proceedings before audit, while allowing the correction of minor defects (such as defects in determining the correct payout in short taxable years, in years of additional contributions, etc.) upon audit so long as there was a good faith attempt to comply with the 1969 Act rules (i.e., the payout is basically expressed as an annuity interest or a unitrust interest).

Secondly, the committee believes that any reformation proceedings necessary to cure defective governing instruments should not be an opportunity to significantly revise the substance of the split interest transfer, especially where the change reduces charity's share of the trust. Accordingly, the committee believes that the relative actuarial values of the interests of each beneficiary before and after the reformation should not differ by more than that 5 percent and that the durations of the interests before and after the reformation should be the same. In addition, to insure that the reformation not be used to increase the amount of any charitable contribution deduction allowed with respect to the original transfer, the committee believes that the deduction under the reformed governing instrument not exceed the actuarial value of the charitable interest before the reformation.

Explanation of Provision

In general

The bill provides a permanent rule permitting reformation of governing instruments of charitable split interest trusts which do not meet the requirements of the 1969 Act rules. In general, such reformations will be allowed where either the instrument evidences an intent to comply with the 1969 Act rules or the reformation proceedings are begun before there is an opportunity by the Internal Revenue Service to audit the matter. In addition, the bill requires that the actuarial values and durations of the charitable and noncharitable interest in the trust generally must remain the same before and after the reformation. These results are achieved under the bill by allowing an income, gift, or estate tax charitable deduction for property passing to charity in respect of any qualified reformation of a reformable interest into a qualified interest.

Qualified reformation

A qualified reformation is a change in the governing instrument of a trust which changes a reformable interest into a qualified interest if two requirements are met. As under present law, the reformation must be retroactive to the date of death in the case of testamentary trusts or the date of creation in the case of inter vivos trusts and should provide for correction of any overpayments or underpayments prior to reformation. In order to insure the proper taxation of the trust and its beneficiaries, the bill provides that the period for assessing any deficiency of any tax shall not expire before the date which is one year after the Secretary of the Treasury is notified that the reformation had occurred.

Under the first requirement, the difference between the actuarial value of the charitable interests of the reformed trust and the unreformed trust cannot exceed 5 percent of the actuarial value of the charitable interest before the reformation.[18]

The second requirement limits changes in the length of the charitable and noncharitable interests in the trust. In the case of a charitable remainder trust, the noncharitable interests must terminate at the same time both before and after the reformation.[19] An exception is made to this rule to permit a noncharitable interest which is for a term of years in excess of 20 years to be reduced to 20 years.[20] In the case of other interests (e.g., charitable lead trusts), the charitable interest must be the same duration under both the reformed and unreformed trusts.

Reformable interest

In order for an interest to be a reformable interest, it must meet two requirements. First, the charitable interest prior to the reformation must have been in a form for which a deduction would have been allowable for that interest under the rules applicable to split interest transfers prior to the Tax Reform Act of 1969.

Second, either the reformation must be commenced[21] within a specified period or, in the case of wills executed after December 31, 1978, the will creating the trust must have evidenced an intent to comply with the 1969 Act. The specified period generally is the period that ends 90 days after the filing date (including extensions) of the estate tax return on which a charitable deduction for the transfer to the trust is claimed. If no estate tax return is required to be filed for such a transfer, the period terminates 90 days after the due date (with extensions) for the first required income tax return for the trust. The committee intends that, in order for the commencement a judicial proceeding to be timely, the pleading must describe the nature of the defect that must be cured. The filing of a general protective pleading is not sufficient.

The governing instrument evidences an intent to comply with the 1969 Act rules if all current payouts from the trust are expressed as a fixed dollar amount or a fixed percentage of the value of the trust's assets. Thus, a trust does not meet this requirement if the governing instrument provides for powers of invasion for a noncharitable beneficiary of any sort. However, the failure to have detailed rules relating to the computation of the fixed dollar amount or the fixed percentage of the value of the trust's assets in special circumstances (e.g., short taxable years, years where there are additional contributions, year when interests terminate, etc.) will not cause the interests to not be reformable interests. In addition, an interest will be treated as expressed as a fixed percentage of the value of the trust's assets if the current payout is expressed as the lesser of trust income or a fixed percentage of the value of the trust's assets or the current payout is expressed in any other formulation which indicates an intent to create a trust described in section 664(d)(3).

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[18] Under the bill, a reformation that changes the relative interests of noncharitable beneficiaries may be a qualified reformation. However, such changes may be gifts from one noncharitable beneficiary to another noncharitable beneficiary.

[19] Where the unreformed trust contains a contingency which accelerates the charitable remainder interest, the actuarial value of the charitable and noncharitable interests before the reformation is to be determined, for this purpose, without regard to the contingency.

[20] In such a case, the amount of the annual noncharitable distributions must be increased to insure that the actuarial value of the charitable and noncharitable interests are the same before and after the reformation.

[21] Where a judicial proceeding is begun in one court, but it is later determined that the proceeding should have been commenced in a different court (for example, where it is determined that jurisdiction over the trust lies in a different State), then the proceeding will be treated as timely filed if the first proceeding was timely filed.

Method of reformation

The bill provides that the qualified reformation can be achieved in any method permitted under applicable local law so long as that change is binding on all relevant parties under applicable local law. Thus, changes can be accomplished by reformation, amendment, construction, or otherwise, so long as those changes are binding on all parties under applicable local law.

In addition, the bill provides the the death of all of the noncharitable "income" beneficiaries of a charitable remainder trust before the filing of the estate tax return (including any extensions) on which the charitable deduction for the transfer to the trust is claimed is to be treated as a reformation of the governing instrument of the trust. In such as case, the charitable deduction is the actuarial value of the remainder interest before the reformation, adjusted for any payments made to those "income" beneficiaries.

Amount of deduction allowed

If there is a qualified reformation, a deduction is allowed for the lesser of (1) the actuarial value of the charitable interest after the reformation or (2) the amount of the actuarial value of the charitable interests prior to the reformation for which a deduction would have been allowable but for the disallowance rules of section 2055(e)(2).[22]

Effect of reformation for other purposes

The bill provides that the Secretary of the Treasury shall prescribe regulations concerning the taxation of trust and the application of the rule relation to exempt organizations and private foundations to trusts which are reformed pursuant to the provisions of the bill. The committee intends that those regulations continue the present law rule that, in the case of a reformation of a charitable remainder trust, the exemption from tax and the income characterization of payments provided by section 664 will be retroactive to the creation of the trust.

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[22] In determining the actuarial value of the charitable interest of the unreformed trust, the Committee intends that trust to which Rev. Proc. 73-9, 1973-1 C.B. 758, apply are to be treated as if they had complied with that revenue procedure.

Pooled income funds, farms, and personal residences

The bill provides that the Secretary of the Teasury is to prescribe rules permitting the reformation of charitable transfers involving remainder interests in pooled income funds, farms, and personal residences. The rules to be prescribed are to be consistent with the rules provided by the bill for reformations of charitable remainder annuity trusts and charitable remainder unitrusts.

Special rule for contingencies in charitable remainder trusts

The bill provides a special exception to the present law rule that the noncharitable interests in a charitable remainder annuity trust or a charitable remainder unitrust must terminate at the end of lives in being or a term of years (not to exceed 20 years). Under the special exception, contingencies in the time that annuity trust interest or unitrust interest payments are to be made, are permitted where a trust provides for annuity trust interests or unitrust interests which terminate at times permitted by present law, but provides that those annuity trust interests or unitrust interests terminate at some earlier time such that the charitable remainder interest is accelerated. For example, under the bill, the annuity trust interest or unitrust interest may be paid for the earlier of death or remarriage of a named individual. In such a case, the value of the charitable remainder is determined without regard to the contingency (i.e., the value of the charitable remainder is determined as if the payments of the annuity trust interest or unitrust interests did not terminate until the periods permitted by present law). For example, where the annuity trust interest or unitrust interest lasts until the earlier of the death or remarriage of a named individual, the value of the remainder interest is determined as if the annuity trust interest or unitrust interests terminated at the death of the named individual.

Effective Date

The amendments made by this section apply to reformations made after December 31, 1978, other than reformations to which present law (as in effect prior to this bill) applies). The bill also provides a special rule which opens the statute of limitations for one year after the date of enactment. Thus, in the case of a reformation in 1979 of a trust created pursuant to a will executed in 1979, the statute of limitations with respect to the estate tax deduction with respect to transfers to the trust or with respect to the income taxation of the trust shall not expire later than one year after the date of enactment. However, where a credit or refund is made which is allowed by reason of the extension of the statute of limitations, no interest is allowable on such claim or refund for the period before 180 days after the Secretary of the Treasury is notified of the reformation.

Revenue Effect

This provision will decrease revenues by less than $5 million per year.

2. Alternate Valuation Date Election (secs. 442 and 443 of the bill and sec. 2032 of the Code)

Present Law

Under present law, the value of property included in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date, which generally is the date six months after the date of the decedent's death. The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. The election may be made whether or not the Federal estate tax liability of the estate is reduced.

Also under present law, the basis of property acquired from a decedent in the hands of the decedent's estate or his heirs generally is the value of that property determined for Federal estate tax purposes (i.e., basis is "stepped up" or "stepped down" to fair market value at death or alternate valuation date).

Reasons for Change

The purpose in providing an election to use the alternative valuation date was to provide relief for estate tax purposes where the value of the property decreased after death so that estate taxes are not inordinate. However, the committee believes that election to use the alternate valuation date has been abused.

Where property has appreciated in value since the date of the decedent's death, it is possible under present law to elect the alternate valuation date to increase the income tax basis of the property even though there is no additional Federal estate tax arising from the election. No estate tax may be due either because the estate is not sufficiently high in value or because the appreciated property is transferred to the decedent's surviving spouse.

Because the purpose of the election to use the alternate valuation date was to provide estate tax relief and not as a general method of avoiding income taxes the committee believes that the election to use the alternate valuation date should be restricted to cases where estate tax consequences are affected.

In addition, the committee believes that there is no reason for requiring that the election be made on a timely fixed estate tax return so long as the Internal Revenue Service is given an adequate opportunity to determine correct tax liabilities after the election is made.

Explanation of Provision

The bill provides that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are both reduced.

The bill also provides that the election to use of the alternate valuation date may be made on the first estate tax filed (whether filed timely or late). Once an election is made, it is irrevocable. Where the election to use the alternate valuation date is made on a late estate tax return, the period for assessing any deficiency shall not expire before the date which is one year after the date the election is made.

Effective Date

These provisions will be effective with respect to decedents dying after the date of enactment of the bill.

Revenue Effect

The provision allowing the election only where it results in a reduction in gross estate and estate tax will increase revenues by less than $10 million annually.

E. Foreign Tax Provisions

1. Resident Aliens (sec. 451 of the bill and sec. 7701(b) of the Code)

Present Law

Resident aliens, like U.S. citizens, are subject to U.S. income tax on their worldwide income at the regular graduated rates. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Certain passive U.S. source income of nonresident aliens is subject to tax at a flat 30-percent rate, while effectively connected income is generally subject to taxation on a net basis at graduated rates. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

The Internal Revenue Code does not define the terms "resident alien" or "nonresident alien." Treasury Regulations generally apply a subjective test and define the terms on the basis of an alien's intentions with regard to the length and nature of his or her stay (Treas. Reg. sec. 1.871-2). In general, under the regulations, residence depends on whether an alien is "a mere transient or sojourner" in the United States. Living in the United States with no definite intention as to the length and nature of his or her stay makes an alien a resident under the regulations. A visa that limits the alien's stay to a definite period makes him or her a nonresident absent "exceptional circumstances." An alien may be a resident for tax purposes although neither a resident for immigration purposes nor present in the United States for half the year (*Tongsun Park* v. *Commissioner*, 79 T.C. No. 17, August 10, 1982). An individual may be a resident of more than one country.

An alien may be taxable as a resident for part of a year and taxable as a nonresident for the balance of the year.

In certain cases, individuals who earn U.S.-source income may seek to minimize their U.S. tax by claiming that they are taxable on a fiscal year basis rather than on a calendar year basis and thereby allocating their U.S. income into more than one fiscal year if such an allocation is beneficial (*e.g.*, if they have income for only a part of some fiscal year).

Reasons for Change

The Committee believes that the tax law should provide a more objective definition of residence for income tax purposes. The Committee believes that present law does not provide adequate guidance with respect to residence status. The Committee understands that an objective definition may allow some aliens who should be taxable as residents to avoid resident status, and would impose resident status on some aliens who are not residents under the current rules. On balance, however, the Committee finds that the certainty that the bill's objective definition provides outweighs other considerations.

The committee believes that aliens who have entered the United States as permanent residents and who have not officially lost or surrendered the right to permanent U.S. residence should be taxable as U.S. residents. These persons have rights that are similar to those afforded citizens (including the right to enter the United States at will); equity demands that they contribute to the cost of running the government as much as citizens.

It is just as clearly appropriate to treat as residents individuals who spend significant time in the United States. While there is no single system that is perfect, the committee believes that a regime that depends on length of stay meets the criteria of objectivity and establishing nexus to the United States and is appropriate. Almost all individuals present in the United States for more than half a year should be taxable as U.S. residents. Moreover, individuals who repeatedly spend significant amounts of time in the United States should have to note their presence with the Internal Revenue Service; if they do not have a closer connection with a foreign country than with the United States and a tax home in that foreign country, they, too, should be taxable as U.S. residents. The committee believes that an average of 122 days of presence over a three year period is a significant amount of time for the purpose of imposing U.S. tax in such circumstances, but that an individual who is present for fewer than 31 days in a year should not be subject to this rule for that year. The committee believes that the Tax Court reached the proper result in the *Park* case, and believes that a residence definition based solely on 183 (or some other number of) days of presence in one year would be inadequate.

The committee recognizes that there are cases in which, because of the reason for the alien's stay in the United States, full U.S. taxation is inappropriate. Accordingly, the bill provides exceptions when aliens come to the United States to teach or to learn rather than for employment, for business, for economic opportunity, for pleasure, for personal or family reasons, for political stability, or for other reasons. Exceptions to the general rules for some students, teachers, and trainees will allow the United States to maintain its paramount position in the field of education. Exceptions also seem appropriate for diplomats and for some persons unable to leave the United States.

The committee believes that alien taxpayers who spend brief amounts of time in the United States before moving here or after moving away should generally not be taxable as residents during those brief periods, or during the time between the brief stays and the time the taxpayer moves. The committee also believes that aliens should not be able to switch back and forth between resident status and nonresident status for short periods, and that there should be no gap in resident status when an alien is a resident for part of two consecutive years.

The committee believes that the bill's definition of residence imposes U.S. tax on aliens only when their relationship with the United States is so close that U.S. inclusion of worldwide income in the tax base is appropriate. (Resident aliens, like U.S. citizens, will continue to credit foreign taxes on foreign income taxes or taxes in lieu thereof.) Special rules to exempt foreign passive income of some (but not all) resident aliens are therefore not appropriate. The committee believes that some wealthy aliens spend much time in the United States because of the political stability or economic opportunities our country affords. The committee believes that these aliens should share with other U.S. persons in the financial responsibility for the operations of the Federal Government, even if most of their income is foreign. For reasons of simplicity, too, the committee does not believe that there should be two classes of residents for tax purposes.

The committee believes that aliens who cannot leave the United States because of a medical condition that arose during their stay here should not automatically be subject to U.S. taxation as residents if here for 183 days. The committee also believes, however, that the Federal Government has contributed to the creation of medical facilities in the United States that are second to none in the world, and that aliens who come to the United States for medical treatment and stay for extended periods of time should be subject to the bill's regular rules.

Explanation of Provision

Definition of resident alien—general rules

The bill provides a definition of resident alien for U.S. income tax purposes. (The bill does not affect the definition of resident for Federal estate or gift tax purposes.) Aliens who do not meet this definition will be nonresident aliens. For income tax purposes, an individual will be considered a resident if the individual:

(1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time—as many as 183 days during a 3-year period weighted toward the present year (the "substantial presence test").[23]

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and a tax home in that country for the year, the individual will generally not be subject to tax as a resident on account of the substantial presence test. For this purpose, tax home means the individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home) (see sec. 911(d)(3)). Thus, maintenance of a U.S. abode will not automatically prevent an individual from establishing a tax home in a foreign country. If an individual is present for as many as 183 days during a year, this closer connections/tax home exception will not be available.

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[23] This substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. An average of 122 days of presence over three years will trigger the test.

An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident will not be eligible for the closer connections/tax home exception. Under current immigration rules, a relative of an alien may apply for the alien to become a lawful permanent U.S. resident. An application by another person will not be relevant under the bill. The closer connections/tax home exception will become unavailable only when an alien takes an affirmative step to seek permanent resident status. Under current procedures, the filing of a Biographic Information form (now Immigration and Naturalization form G-325A) will constitute an affirmative step to seek permanent resident status when another individual has begun the immigration procedure for the alien.

In addition, certain individuals (foreign government related individuals, teachers, trainees, and students) that meet the substantial presence test will generally be nonresident aliens unless the facts and circumstances indicate that they intend to reside permanently in the United States.

The bill defines the term "foreign government-related individual" to mean any individual temporarily present in the United States by reason of (1) diplomatic status, or a visa which the Secretary of the Treasury (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status; (2) being a full-time employee of an international organization; or (3) being a member of the immediate family of such a diplomat or international organization employee.

The term "teacher or trainee" means any individual who is temporarily present in the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act[24] (other than as a student), and who substantially complies with the requirements for being so present. An individual will not be able to establish substantial compliance with this or any visa requirement relevant to residence for tax purposes merely by showing that his or her visa had not been revoked.

A "student" is any individual who is temporarily present in the United States either under subparagraph (F) of section 101(15) of the Immigration and Nationality Act,[25] or as a student under sub-

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[24] Subparagraph (J) of section 101(15) of the Immigration and Nationality Act now applies to "an alien having a residence in a foreign country which he has no intention of abandoning who is a bona fide student, scholar, trainee, teacher, professor, research assistant, specialist, or leader in a field of specialized knowledge or skill, or other person of similar description, who is coming temporarily to the United States as a participant in a program designated by the Secretary of State, for the purpose of teaching, instructing or lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training and who, if he is coming to the United States to participate in a program under which he will receive graduate medical education or training, also meets the requirements of section 1182 of this title, and the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation would change from time to time as the definition in the Immigration and Nationality Act changes.

[25] Subparagraph (F) of section 101(15) of the Immigration and Nationality Act now applies to "(i) an alien having a residence in a foreign country which he has no intention of abandoning, who is a bona fide student qualified to pursue a full course of study and who seeks to enter the United States temporarily and solely for the purpose of pursuing such a course of study at a college, university, seminary, conservatory, academic high school, elementary school, or other academic institution or in a language training program in the United States, particularly designated by him and approved by the Attorney General after consultation with the Secretary of

Continued

paragraph (J) of such section 101(15), and who substantially complies with the requirements for being so present.

An individual cannot be exempt from the substantial presence test as a teacher or trainee if he or she has been exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. An individual cannot be exempt from the substantial presence test as a student if he or she has been exempt as a teacher, trainee, or student for more than five calendar years, unless that individual establishes to the satisfaction of the Secretary of the Treasury that he or she does not intend to reside permanently in the United States and that he or she has substantially complied with the requirements of the student visa providing for the individual's temporary presence into the United States.

An individual who cannot physically leave the United States because of a medical condition that arose during the individual's presence here is eligible for the closer connections/tax home exception to the substantial presence test even if present here for more than 182 days during the year. The Committee anticipates that few individuals will be physically unable to leave the United States. For example, an individual who is in a serious automobile accident shortly before a planned departure date could come within this category. These individuals will have to establish to the satisfaction of the Secretary of the Treasury that they qualify for this special medical exception.

The bill defines lawful permanent resident to mean an individual who has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, if such status has not been revoked or administratively or judicially determined to have been abandoned. Therefore, an alien who comes to the United States so infrequently that, on scrutiny, he or she is no longer legally entitled to permanent resident status, but who has not officially lost or abandoned that status, will be a resident for tax purposes.

Presence during a day will be presence at any time during the day. Regular commuters to employment or self employment in the United States from a place of residence in Canada or Mexico will not be treated as present in the United States on days when they so commute.

The Secretary of the Treasury is authorized to require aliens who claim exemption from the substantial presence test (whether under the closer connection/tax home exception or any other exception) to file statements explaining the basis for their exemption. It will be within the discretion of the Secretary to impose such requirements by regulation.

A taxpayer who has not established a taxable year for any prior period will be taxed on a calendar year basis. A taxpayer who establishes a fiscal year will determine residence on a calendar year

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Education, which institution or place of study shall have agreed to report to the Attorney General the termination of attendance of each nonimmigrant student, and if any such institution of learning or place of study fails to make reports promptly the approval shall be withdrawn and (ii) the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation would change from time to time as the definition in the Immigration and Nationality Act changes.

basis, and will be subject to tax as a resident for any portion of his fiscal year within a calendar year of residence.

The definition of resident alien contained in the bill could conflict with existing treaty obligations of the United States. That is, the definition in the bill could cause an alien to be a U.S. resident, while "tie-breaker" rules in an income tax treaty could indicate that the alien is a resident of the treaty partner (see, e.g., Article 4 of the U.S. Model Income Tax Treaty, and Article 4(2) of the U.S.-United Kingdom Income Tax Treaty). The Committee does not intend to override treaties on this point; therefore, in such a case, the treaty definition will prevail, and such an alien will not be taxable as a resident of the United States.

The Committee, in changing the definition of U.S. residence for U.S. tax purposes, is not changing the definition of foreign residence for U.S. tax purposes. Therefore, the term "bona fide resident of a foreign country" for the purposes of the tax benefits for foreign earned income will retain its current meaning (sec. 911(d)(1)(A)). Therefore, a U.S. citizen who is present in a foreign country for 183 days during a calendar year will not automatically be a "bona fide resident" of that country.

Time of residence

Beginning of residence

An alien who was a U.S. resident during the preceding calendar year and who is a U.S. resident for the current year will continue to be taxable as a resident at the beginning of the current year. That is, residence for tax purposes will not lapse, but will continue throughout both years. For example, an alien who is present in the United States from January 1 to August 1 in 1984 and from June 1 to December 31 in 1985 will be a U.S. resident for all of 1984 and 1985. Similarly, an alien who is present in the United States from January 1 to August 1 in 1984, who first arrives in the United States in 1985 on December 1, and who becomes a lawful permanent U.S. resident on December 1, 1985, will be a U.S. resident for all of 1984 and 1985.

An alien who was not a U.S. resident during the preceding calendar year but who is a U.S. resident for the current year will begin to be a resident for tax purposes on his or her residency starting date, which may not be the beginning of the current year.

An alien who first becomes a lawful permanent resident (and thus first satisfies the "green card" test) during the year will ordinarily begin to be a U.S. resident for tax purposes on the first day he or she was present in the United States while a lawful permanent resident of the United States. If the alien was a U.S. resident during the preceding year, however, residence for tax purposes will not lapse, but will continue throughout both years.

An alien who was not a resident during the preceding year but who satisfies the substantial presence test for the current year will ordinarily begin to be a U.S. resident for tax purposes on the first day during the year when he or she is physically present in the United States. The bill creates an exception, however, for certain nominal presence during the year. (This nominal presence exception does not postpone the beginning of residence under the "green card" test.) If an alien meets only the substantial presence test for the year, but spends time in the United States when he or she has a closer connection to a foreign country than to the United States, the alien may not begin to be a resident for tax purposes during a period of ten or fewer days during that time. The purpose of this nominal presence exception is to allow brief presence in the United States (for example, for business or for house-hunting) before moving to the United States without triggering residence status.

For example, an alien (who has never before been a U.S. resident for tax purposes) who lives in Spain until May 15, who moves to the United States on May 15 and who remains in the United States through the end of the year will begin to be a U.S. resident for tax purposes on May 15. Similarly, an alien (who has never before been a U.S. resident for tax purposes) who lives in Spain until May 15, who comes to a business meeting in the United States on February 2 through 8, who moves to the United States on May 15 and who remains in the United States through the end of the year will begin to be a U.S. resident for tax purposes on May 15, if he or she can establish a closer connection to a foreign country (presumably Spain in this example) than to the United States for the period of U.S. presence in February. However, the Committee does not believe that an alien will end (or begin) a closer connection with a foreign country while physically present in the United States. For example, an alien continuously present in the United States from May 1 to December 31 only, during a year, will not be eligible for this nominal presence rule for any part of the first ten days of May.

If an alien was not a resident during the preceding year but satisfies the substantial presence test as well as the "green card" test for the current year, his or her residence for tax purposes will begin on the earlier of (1) the first day he or she was a lawful permanent resident of the United States or (2) his or her residency starting date under the substantial presence test. For example, if such an alien (1) is present in the United States from January 1 to May 1 and from October 1 to December 31 and (2) first meets the "green card" test on November 1, his or her residence for tax purposes will begin on January 1.

Termination of residence

An alien who is a U.S. resident during the current year and who is a also a U.S. resident for part of the following year will be taxable as a resident through the end of the current year. That is, residence for tax purposes will not lapse, but will continue throughout both years. An alien who is a U.S. resident during the current year but who is not a U.S. resident for the following year may or may not be taxable as a U.S. resident through the end of the current year.

An alien who ceases to be a lawful permanent resident (and thus ceases to satisfy the "green card" test) during the year will typically cease to be a U.S. resident for tax purposes on the first day he or she is no longer a lawful permanent resident of the United States. If the alien is a U.S. resident (under either the "green card" test or the substantial presence test) during the following year, however, residence for tax purposes will not lapse, but will continue throughout both years.

An alien who is not a resident during the following year but who satisfies the substantial presence test for the current year will ordinarily cease to be a U.S. resident for tax purposes on the last day during the year when he or she is physically present in the United States. The bill creates an exception, however, for certain nominal presence during the year. If an alien meets only the substantial presence test for the year, but spends time in the United States when he or she has a closer connection to a foreign country than to the United States, the alien may not be a resident for tax purposes during a period of ten or fewer days during that time. The purpose of this nominal presence exception is to allow brief presence in the United States (for example, for business or for disposing of a U.S. residence) without extending residence status. Again, this nominal presence exception does not apply to aliens meeting the "green card" test.

For example, an alien (who is not during the following year a U.S. resident for tax purposes) who lives in the United States until September 15, who moves to Brazil on September 15, and who does not return to the United States during the year will cease to be a U.S. resident for tax purposes on September 15. Similarly, an alien (who is not during the following year a U.S. resident for tax purposes) who lives in the United States until September 15, who moves to Brazil on September 15, and who comes to a business meeting in the United States on November 2 through 8 will cease to be a U.S. resident for tax purposes on September 15, if he or she can establish a closer connection to a foreign country (presumably Brazil, in this example) than to the United States for the period of U.S. presence in November.

If an alien is not a resident during the following year but satisfies the substantial presence test as well as the "green card" test for the current year, his or her residence for tax purposes will end on the later of (1) the first day he or she is no longer a lawful permanent resident of the United States or (2) the last day he or she was a resident under the substantial presence test. For example, if an alien who is not a resident during the following year (1) is present in the United States from January 1 to August 1 and from October 1 to October 5, (2) can establish a closer connection to a foreign country than to the United States for the period of U.S. presence in October, and (3) suffers revocation of his or her "green card" on November 1, his or her residence for tax purposes will end on November 1. If "green card" revocation occurred on September 15 in this example, however, residence would end on September 15. If "green card" revocation occurred on October 3, residence would end on October 3. If "green card" revocation occurred on March 5, residence would end on August 1.

Effective Date

These provisions will apply to taxable years beginning after December 31, 1983. However, pre-1984 presence of an alien who was not a resident (under current law) at the close of 1983 will not count in the substantial presence test; pre-1983 presence of an alien will count only if that individual was a resident (under current law) at the end of both 1982 and 1983.

Revenue Effect

The provisions will increase budget receipts by less than $10 million annually.

2. Treatment of Community Property Income of Nonresident Aliens (sec. 452 of the bill and sec. 879 of the Code)

Present Law

Nonresident aliens are subject to U.S. tax at the regular graduated rates on income that is effectively connected with the conduct of a trade or business within the United States. If one spouse is a U.S. citizen or resident while the other is a nonresident alien, the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse is generally treated as the income of that spouse (sec. 879). Therefore, if that income is effectively connected income, the couple generally may not split that income for U.S. tax purposes by use of community property laws. However, if both spouses are nonresident aliens from a community property country, they may be able to split the effectively connected income of one spouse to reduce their U.S. tax liability. A comparable couple from a common law country cannot split income in this way.

Reasons for Change

The committee believes that the U.S. income tax treatment of nonresident aliens from community property countries should be the same as the U.S. income tax treatment of nonresident aliens from common law countries. A graduated income tax like that of the United States imposes less tax on a given amount of income if the income belongs to more than one person. Therefore, when married taxpayers split their income, they generally reduce their combined tax liability. The committee does not believe that nonresident aliens who earn income that is effectively connected with a U.S. trade or business should be able to split that income for U.S. tax purposes by virtue of foreign community property laws. Furthermore, it does not believe that such a couple should be taxed more favorably than a similarly situated U.S. couple.

Explanation of Provision

The bill provides that, for U.S. income tax purposes, a married couple both of whom are nonresident alien individuals would treat the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse as the income of that spouse, regardless of any community property laws. That spouse will be subject to U.S. tax at the regular graduated rates applicable to married persons filing separate returns when such income is effectively connected with the conduct of a U.S. trade or business.

Effective Date

This provision will apply to taxable years beginning after December 31, 1983.

Revenue Effect

This provision will reduce budget receipts by less than $1 million annually.

3. Foreign Personal Holding Company Attribution Rules (sec. 453 of the bill and secs. 551 and 554 of the Code)

Present Law

Congress enacted the foreign personal holding company rules to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily foreign personal holding company income (generally passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50 percent of gross income)), that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. That is, though only individuals count in the determination of foreign personal holding company status, persons other than individuals may be subject to foreign personal holding company tax.

Family attribution [illegible] characterization as a foreign personal holding company

The foreign personal holding company provisions contain constructive ownership [illegible] that determine whether a foreign corporation is more than [illegible] percent owned by five or fewer United States citizens [illegible] residents. These rules treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. One case, however, casts doubt on the operation of these constructive ownership rules when nonresident aliens are the only family members who own stock in a foreign corporation.[26]

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appears to be large amounts of rental income.

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[26] In *Estate of Nettie S. Miller v. Commissioner*, 43 T.C. 760 (1965), nonacq., 1966-1 C.B. 4, two Canadian sisters owned over half the stock of a Canadian corporation. A divided Tax Court, despite the language of the statute, declined to attribute their stock to their brother, a U.S. citizen and resident, who owned none of the stock. Therefore, the corporation was not a foreign personal holding company, so its U.S. shareholders, who were unrelated to the Canadian sisters, were not subject to tax.

Income inclusion through foreign entity

Shareholders in a foreign personal holding company who are U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than estates and trusts whose gross income includes only income from sources within the United States)[27] must include their share of undistributed foreign personal holding company income in their gross income. These shareholders are called "United States shareholders". If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

Interposition of a foreign partnership, a foreign corporation other than a foreign personal holding company, or an estate or a trust whose gross income includes only income from sources within the United States between a taxpayer and a foreign personal holding company, however, arguably may allow avoidance of the foreign personal holding company rules. Although stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries for the purpose of determining whether a corporation is a foreign personal holding company, some taxpayers have taken the position that these tracing rules do not necessarily apply to impose a tax on the ultimate owners of a foreign personal holding company.

Reasons for Change

The foreign personal holding company provisions have been in the law since 1937 and serve an important purpose in removing the tax incentive to shift assets offshore often to tax havens. Two technical problems have come to the committee's attention. First, the committee believes that attribution of ownership from a nonresident blood relative for the purpose of determining whether a foreign corporation is a foreign personal holding company is generally inappropriate, particularly where the U.S. person to whom the stock is attributed owns no stock. Second, the committee is aware that the present rules have allowed taxpayers to take the position that they can circumvent the foreign personal holding company rules by interposing foreign entities between themselves and foreign personal holding companies. This abuse of the system was not intended and should be stopped.

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[27] This excluded category of estates and trusts corresponds generally to the definition of "foreign estate or trust" in Internal Revenue Code section 7701(a)(31). Therefore, in general, estates or trusts that are United States persons are subject to the same treatment as U.S. citizens or corporations.

Explanation of Provisions

Family attribution for characterization as a foreign personal holding company

The bill repeals, for the purpose of determining whether five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation, the rules that attribute ownership of stock actually owned by a nonresident alien to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants. There will nonetheless be, for that purpose, attribution of ownership of stock actually owned by a nonresident alien to the alien's U.S. spouse and partners. This attribution will occur even when the U.S. spouse or partner owns no stock in the foreign corporation. For example, if the nonresident alien partner of a U.S. citizen owns 60 percent of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40 percent, the foreign corporation will be (if it meets the other criteria) a foreign personal holding company. The bill will not affect the current attribution rules that operate to treat certain income from personal services and income from certain use of corporate property as foreign personal holding company income.

Income inclusion through foreign entity

The bill adds a tracing rule that makes it clear that taxpayers cannot interpose foreign corporations (other than foreign personal holding companies), foreign partnerships, estates or trusts whose gross income includes only income from sources within the United States, or other entities between themselves and the foreign corporation to avoid the foreign personal holding company rules. The bill provides that stock of a foreign personal holding company that is owned by a partnership, estate, or trust that is not a U.S. shareholder, or by a foreign corporation that is not a foreign personal holding company, will be considered (for income inclusion purposes) as being owned proportionately by its partners, beneficiaries, or shareholders. This rule will apply to trace ownership and attribute income through tiers of such entities. The bill grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the foreign personal holding company rules as may be necessary to carry out the purposes of this rule. Such an adjustment could be necessary, for example, to prevent double taxation of foreign personal holding company income.

This situation could arise in a case where a U.S. person owns shares in a foreign corporation which is not a foreign personal holding company which in turn owns stock in a foreign corporation that is a foreign personal holding company. Under the bill, the U.S. person could be subject to tax on his pro rata share of the income of the foreign personal holding company and, unless an adjustment were made, could be subject to tax again upon a dividend distribution from the same earnings from the foreign personal holding company which, in turn, is redistributed as a dividend by the foreign corporation to the U.S. shareholder. The Committee intends that rules similar to those contained in section 959 apply.

Effective Date

The provisions will generally apply to taxable years of foreign corporations beginning after December 31, 1983. However, the rules relating to interposed foreign entities will apply to taxable years of foreign corporations beginning after December 31, 1984, with respect to the stock of foreign corporations owned continuously by the same entity since June 30, 1973.

Revenue Effect

These provisions will have a negligible revenue effect.

4. Ordinary Income Treatment on Disposition of Stock of Certain Foreign Corporations (sec. 454 of the bill and secs. 959 and 1248 of the Code)

Present Law

When a U.S. person sells or exchanges stock of a controlled foreign corporation (generally, a foreign corporation of which more than half of the combined voting power of all classes of stock entitled to vote is owned directly, indirectly, or constructively by U.S. persons who own 10 percent or more of that voting power), some of the gain may be taxed as ordinary income, not as a capital gain (Code sec. 1248(a)). The purpose of this rule is to deny capital gains treatment to income accumulated in foreign corporate solution that has not been taxed by the United States. The gain is ordinary (dividend) income rather than capital gain only to the extent of post-1962 earnings and profits (E&P) accumulated while the shareholder held the shares and that were not previously taxed by the United States.

The Internal Revenue Code also imposes tax at ordinary income rates in certain cases upon certain distributions by a domestic corporation, or the liquidation of a U.S. corporation, that owns stock of a controlled foreign corporation (sec. 1248(f)). This rule requires inclusion as a dividend in the income of the U.S. corporation an amount equal to the difference between the value of the domestic corporation's stock in the controlled foreign corporation and its adjusted basis in that stock to the extent of untaxed post-1962 E&P accumulated while the liquidating corporation held the shares.

Double counting.—If a U.S. person owns stock in a controlled foreign corporation and disposes of such stock at a gain to another U. S. person, the U.S. person's gain is recharacterized as dividend income in an amount equivalent to the accumulated E&P of the controlled foreign corporation, but the Internal Revenue Service has taken the position that such income inclusion does not reduce the E&P of the controlled foreign corporation by the amount of that income inclusion (see Rev. Rul. 71-388, 1971-2 C.B. 314). That is, the taint of the previously untaxed E&P remains even though the E&P has borne tax. A subsequent distribution by the controlled foreign corporation could therefore cause dividend treatment on account of E&P that had already caused a dividend inclusion. In addition, the new owner may take the position that it is entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner (the selling corporation) has already credited. This double credit, if current law allows it, could reduce U.S. tax on other foreign income twice.

Similarly, when a U.S. corporation in a section 311, 336 or 337 transaction disposes of an interest in a controlled foreign corporation, it recognizes dividend income in an amount equivalent to the difference between the fair market value and its cost basis in the shares distributed, to the extent of the accumulated E&P of the controlled foreign corporation. It is not entirely clear whether the E&P of the controlled foreign corporation is reduced in the hands of the distributee. If the distributee receives a distribution from the controlled foreign corporation, it may be subject to tax at ordinary income rates on account of the E&P accumulated while the distributee owned the stock if E&P is not reduced. Taxpayers could attempt to credit the same taxes twice in this case also.

Indirect ownership.—Some taxpayers take the position that they may avoid ordinary income treatment on E&P of a controlled foreign corporation by a series of transactions between related parties. The first step in this series is the contribution of the stock in the corporation (a first-tier foreign subsidiary of a U.S. parent) to the capital of a second controlled foreign corporation (also a first-tier subsidiary of the U.S. parent). The second step is the sale or exchange of the stock of the second controlled foreign corporation (which now owns the first controlled foreign corporation). Taxpayers contend that the E&P that the first foreign corporation accumulated before the contribution of its stock to the second corporation is not subject to ordinary income treatment. They take the position that a cross-reference in the Code (sec. 1248(c)(2)(D)(ii)) indicates that E&P accumulated during direct ownership does not count when a U.S. person disposes of an interest held indirectly (as a second-tier subsidiary).

Reasons for Change

Section 1248 of the Code was intended to recapture at ordinary income rates the income of active foreign corporations the U.S. tax on which has been deferred. While the section has generally carried out this policy certain technical problems have come to the Committee's attention. In one case the technical problem relates to the changes made in the Tax Reform Act of 1976, which generally closed unintended loopholes. The committee believes that the present law rules described above are unclear, at times possibly causing hardship in the form of a double tax and at times possibly giving taxpayers unintended benefits. The technical changes contained in the bill will clarify the operation of those rules. The Committee is aware that the present rules are unclear, and intends no inference that they work as described.

Explanation of Provisions

Double counting.—The bill provides that to the extent that accumulated E&P has previously characterized income as ordinary income, that same E&P will not again characterize income as ordinary income. Therefore, if a a U.S. corporation owns stock in a controlled foreign corporation and that U.S. corporation liquidates, the dividend income generated on account of the accumulated E&P of the controlled foreign corporation will reduce the E&P of the controlled foreign corporation by the amount of that income inclusion. Similarly, if a U.S. person sells its interest in a controlled foreign corporation and recognizes dividend income on account of accumulated E&P, that income inclusion will, in effect, reduce the E&P of the controlled foreign corporation. The bill further clarifies present law to provide that, in any case, the new owner will not be entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner had already credited.

Indirect ownership.—The bill clarifies current law to provide that E&P that an controlled foreign corporation accumulated while controlled by U.S. owners is subject to ordinary income treatment whether its U.S. owners controlled it directly or indirectly.

Effective Date

These provisions will each apply to sales or exchanges of stock of controlled foreign corporations that occur after the date of enactment. The double-counting provision will apply (upon an election) to transactions occurring after October 9, 1975 (the effective date of certain changes to Code section 1248). In the case of sales or exchanges of foreign corporate shares, the foreign corporation (or its successor in interest) is eligible to make the election. If a foreign corporation that would be eligible to make an election has been liquidated by the date of enactment or within the election period, its successors in interest shall be determined under rules similar to rules provided under section 964. In the case of a section 311, 336 or 337 transaction by a U.S. corporation that owns stock of a controlled foreign corporation, the distributing U.S. corporation or its successor is eligible to make the election. In either event, any election applies to all eligible post-October 9, 1975 transactions of the electing corporation. The corporation is to make the election within 180 days after enactment.

Revenue Effect

These provisions will have a negligible revenue effect.

5. Coordination of Subpart F with Foreign Personal Holding Company Provisions (sec. 455 of the bill and sec. 951 of the Code)

Present Law

Congress enacted the foreign personal holding company rules in 1937 to prevent U.S. taxpayers from accumulating investment income tax-free in foreign "incorporated pocketbooks." In 1962, Congress imposed tax on the U.S. shareholders of foreign corporations engaging in certain tax-haven type activities by adding the Subpart F rules to the Internal Revenue Code. The Subpart F rules, as amended, impose tax when a controlled foreign corporation has "Subpart F income," and in other circumstances.

Subpart F income includes income from related party sales and services transactions through tax haven-type base companies, from insurance of U.S. risks, from shipping operations (unless the income is reinvested), from foreign oil related activities, and from passive investments. Some of this income may also be taxable under the 1937 foreign personal holding company rules as amended. Subpart F imposes a tax (although not on "Subpart F income") in other circumstances, such as investment by a controlled foreign corporation of its earnings in U.S. property, and a controlled foreign corporation's withdrawal of its previously excluded income from shipping operations.

Where the foreign personal holding company rules and the Subpart F rules overlap, the foreign personal holding company rules generally take priority (sec. 951(d)). A taxpayer who is subject to tax under the foreign personal holding company rules may contend that it is not subject to the Subpart F rules that year. For instance, taxpayers (who are shareholders in a foreign corporation that is both a foreign personal holding company and a controlled foreign corporation) have taken the position that being subject to foreign personal holding company tax for a taxable year exempts them from taxation under Subpart F on investment that year in U.S. property of earnings of the foreign corporation. Because historical earnings invested in U.S. property, for example, might be substantially greater than current income taxed under the foreign personal holding company rules, such a position, if sustained, could undercut much of Subpart F. Courts have split on this issue. *Compare Whitlock* v. *Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (holding the taxpayer liable for tax under Subpart F), *with Lovett* v. *United States*, 621 F.2d 1130 (Ct. Cl. 1980) (holding that no Subpart F tax was due).

Reasons for Change

The Code provision governing the overlap of Subpart F and the foreign personal holding company rules has produced uncertainty and some questionable results. The committee believes that U.S. taxpayers should be subject to tax on the full amount of the tainted earnings of their foreign corporations, not more and not less. However, no inference as to the proper result under present law is intended.

Explanation of Provision

The bill repeals the rule of section 951(d) that taxation under the foreign personal holding company rules precludes taxation under the Subpart F rules. It substitutes a new mechanism for the avoidance of double taxation by providing that a controlled foreign corporation's Subpart F income is taxed under Subpart F—but not under the foreign personal holding company rules—to the extent that it would otherwise be taxable under both Subpart F and the foreign personal holding company rules. Therefore, the existence of income subject to tax under the foreign personal holding company rules will not preclude taxation under Subpart F. Income includible under only one set of rules (foreign personal holding company rules or Subpart F rules) will be includible under that set of rules. A taxpayer taxable under Subpart F on amounts other than Subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) will be taxable under Subpart F whether or not its foreign corporation subjected it to foreign personal holding company tax.

Effective Date

This provision will apply to taxable years of U.S. shareholders beginning after the date of enactment.

Revenue Effect

This provision will result in a revenue gain of less than $5 million during each fiscal year during the period 1984-1988.

6. Stapled Stock (sec. 456 of the bill and new sec. 269B of the Code)

Present Law

Taxpayers have devised schemes for tax avoidance wherein the stock of two (or more) entities is "stapled" or "paired" so that a shareholder cannot trade the stock separately. Typically, however, the management of the two entities is the same.

Foreign corporations whose shares are sufficiently dispersed among U.S. persons are not subject to certain U.S. tax rules. The anti-tax-haven rules of Subpart F of the Code and the anti-international boycott rules apply to foreign corporations only if more than 50 percent of the total combined voting power of their stock is owned (directly or indirectly) by U.S. shareholders owning at least 10 percent of the stock each. The foreign personal holding company rules apply only if more than 50 percent of a corporation's outstanding stock (in value) is owned (directly or indirectly) by five or fewer U.S. shareholders. Widely held U.S. corporations have attempted to avoid these rules by splitting off their foreign operations and conducting them through separate corporations.

The stock of the foreign corporation is "stapled to" or "paired with" the stock of the original U.S. company so that a shareholder cannot buy or sell the stock of one corporation without buying or selling the stock of the other. Assuming the U.S. corporation, and thus the new foreign corporation, are sufficiently widely held, this device arguably reaches the result that the new foreign corporation is not subject to the subpart F and anti-boycott rules because the 10-percent shareholder test is not met. This device may similarly allow avoidance of the foreign personal holding company rules. It is not clear, however, that these split-offs have the tax consequences that these U.S. corporations seek. Although there is authority that would tend to support the integrity of these split-offs, see, e.g., Rev. Rul. 54-140, 1954-1 C.B. 116, other authority indicates that the courts will not respect the formation of such a "quasi-subsidiary." *De Coppet* v. *Helvering*, 105 F.2d 787 (2d Cir. 1940), *cert. denied*, 310 U.S. 646.

Stapling of stock of two or more U.S. corporations could allow shareholders to benefit from multiple surtax exemptions and from multiple accumulated earnings tax credits. In addition, one stapled entity may qualify for special tax treatment as a Real Estate Investment Trust (REIT) or a Regulated Investment Company (RIC). This special treatment would not be available if the operations of the companies were consolidated.

In these examples, and potentially in other cases where tax benefits among related parties are limited or where tax penalties may be imposed on related parties, companies may use stapled stock to appear to be unrelated.

Reasons for Change

The committee believes that the stapling of corporate stock is a simple means of attempting to avoid tax rules intended to limit abuse of the U.S. tax system or to limit the use of special tax benefits granted by Congress. Stapling of a taxable entity with a nontaxable entity is a particularly serious problem. In such a case, the shareholders (who are the same for both corporations) generally prefer profits to be realized in the nontaxable entity rather than in the taxable entity. The committee believes that not to do something to preclude the use of such a transparent device would lead to disrespect for the tax system.

Transfer pricing.—Shareholders of stapled stock may have no business reason to complain if their taxable entity undercharges their nontaxable entity for goods or services.[28] If stock is not stapled, by contrast, the shareholders of a company can sue its management (in a shareholders' derivative suit) if it undercharges another entity. The United States has the right to correct improper transfer prices between related parties (sec. 482), but has found it difficult to do so in practice.[29]

The problem of transfer pricing arises on stapling of a special-purpose U.S. entity with another U.S. corporation. For instance, an ordinary corporation stapled to a Real Estate Investment Trust (REIT) that leases real property from the REIT may not object to a premium rental price, because the non-REIT's profits are subject to corporate tax while the REIT's are not. The problem of transfer pricing also arises on stapling of a U.S. corporation with a foreign corporation operating in a low-tax jurisdiction or in a tax haven.

Stapled foreign entities.—Stapling may also allow avoidance of the anti-tax-haven rules and the anti-boycott rules. Stapling can allow a U.S. company establishing foreign operations to avoid the U.S. corporate tax on dividends received from a subsidiary by establishing a stapled sister corporation rather than a subsidiary. Stapling a U.S. corporation with a foreign corporation could also raise issues of corporate opportunity. If either company could deal profitably with a new foreign customer or supplier, the shareholders may prefer that the foreign, nontaxable entity do so. The directors may not owe a duty to U.S. shareholders to seek business for the U.S. company.

Stapled U.S. entities.—The committee believes that stapling special purpose U.S. tax entities to ordinary U.S. entities threatens the policy that led Congress to create those special purpose U.S. tax entities. For example, Congress granted special tax status to corporations that qualify as REITs to allow small investors to invest in real estate. For that reason, REITs must concentrate their investments in real estate. If small investors buy shares in another corporation stapled to REIT shares, their investment in qualified real estate activities is diluted. Congress intended no such dilution when it enacted the REIT provisions.

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[28] If a U.S. corporation owns equal interests in a U.S. corporation and a nontaxed foreign corporation, it may prefer to have the next dollar of earnings go to the U.S. corporation (in which it owns stock) rather than the foreign corporation. If the effective U.S. tax rate (on the income of the corporation earning the marginal income) is low, the 85-percent dividends received deduction may outweigh the benefits of deferral for the U.S. corporate shareholder.

[29] See Comptroller General of the United States, Report to the Chairman, House Committee on Ways and Means, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981.

In addition, stapling arguably allows taxpayers multiple surtax exemptions and multiple accumulated earnings tax exemptions. The committee believes that such multiple exemptions are inappropriate.

Unusual circumstances.—The committee has taken notice of some unusual circumstances involving stapled stock. The committee believes that the United States should not tax a REIT stapled at the time of introduction of H.R. 3475 because the Internal Revenue Service, in several private letter rulings, explicitly sanctioned stapling of REITs. The committee also believes that the United States should not tax a stapled foreign corporation on income that was exempt from U.S. tax under a treaty at the time of introduction, because such taxation could violate the realistic expectations of our treaty partners. The committee also believes that the United States should not tax certain pre-existing stapled Puerto Rican corporations, because the possessions corporation rules (sec. 936) offer tax benefits comparable to those of stapling. The committee believes that all stapled entities should have adequate time to remove the requirement that shares trade in tandem, and that adequate time in the case of foreign stapled entities will typically be greater than adequate time in the case of domestic entities.

Explanation of Provision

The bill provides generally that where a foreign and a domestic corporation are stapled entities, the foreign corporation will be treated as domestic. Therefore, the stapled foreign corporation will be subject to U.S. tax on its worldwide income. The characterization of a foreign corporation as a U.S. corporation will not be subject to the rules of section 367, because distributions from the newly domestic corporation will be subject to U.S. tax.

If a foreign corporation and a U.S. corporation were stapled entities on June 30, 1983, the U.S. corporation may elect to be treated as owning all interests in the foreign corporation that constitute stapled interests with respect to stock of the U.S. corporation. To the extent that the stock of both companies is stapled, the U.S. corporation will, upon this election, be subject to tax on certain income of the foreign corporation, including its Subpart F income, if any. Also, if some of the stock of the foreign corporation (1) is not stapled to stock of the U.S. corporation and (2) belongs to non-U.S. shareholders, then (after an election to treat the foreign corporation as a foreign subsidiary of the U.S. corporation) earnings attributable to that stock or dividends to a foreign shareholder will not generally be subject to current U.S. tax. An election to treat a foreign corporation as a foreign subsidiary of a U.S. corporation must be made not later than 180 days after the date of enactment, and in such manner as the Secretary or his delegate shall prescribe. This election will be revocable only with the consent of the Secretary or his delegate.

The stapled stock provision generally overrides treaties. However, the bill will not restrict treaty benefits in the case of entities stapled on June 30, 1983, to which those entities were entitled on that date, so long as those entities remain entitled to those benefits under the applicable treaty. If treaties are renegotiated to eliminate benefits for stapled companies (a result that would be consistent with the committee's intent), stapled companies would lose current treaty benefits. For example, the bill provides that a foreign corporation stapled to a U.S. corporation is taxable as a U.S. corporation. A treaty may provide, for example, that a corporation incorporated under the laws of the treaty partner is not taxable in the United States on industrial or commercial profits unless it has a U.S. permanent establishment (see, e.g., Article III(1) of the U.S.-Netherlands Income Tax Treaty). In such a case, a foreign corporation stapled on June 30, 1983 to a U.S. corporation will be entitled to applicable treaty benefits.

Stock in one corporation which constitutes a stapled interest with respect to stock of a second corporation will generally be treated as owned by the second corporation for purposes of Code section 1563; the effects of this section 1563 treatment include denial of multiple surtax exemptions and denial of multiple accumulated earnings tax credits. All stapled entities will generally be treated as one in determining whether any one is a REIT or RIC. These rules will be subject to modification by the Secretary of the Treasury by regulation. In addition, the Secretary of the Treasury is to prescribe such regulations as will be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations will include, but will not be limited to, regulations providing the extent to which one stapled entity will be treated as owning another stapled entity (to the extent of the stapled interest).

Under the standard rules governing consolidated returns, stapled U.S. corporations will not generally be eligible to file consolidated returns. Under the same rules, a foreign corporation that is stapled to a U.S. corporation will not be eligible to file a consolidated return with its U.S. sister (whether or not an election to treat the foreign sister as owned by the U.S. company to the extent of the stapling is in effect). A contiguous country stapled corporation described in section 1504(d) might be eligible to consolidate under the regular rules, however. The bill defines the term "entity" to mean any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity. The bill defines the term "stapled entities" to mean any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consisted of stapled interests. Two or more interests will be stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of such interests the other such interests will be also transferred or will be required to be transferred.

For example, assume that two U.S. citizens each own 50 percent of a U.S. corporation and a foreign corporation. Under two separate standard death redemption agreements, the corporation agrees to buy, and each shareholder obligates his estate to sell, all of the shares of the first shareholder to die. These shares are not necessarily stapled for purposes of the bill, so long as each shareholder may trade shares of the two corporations freely before death.

Again assume that two U.S. citizens each own 50 percent of a U.S. corporation and a foreign corporation. Under two separate standard right of first refusal agreements, neither shareholder may sell or exchange any of the shares of either corporation without allowing the other shareholder (or, alternatively, the corporation) the right to match the price offered for his or her shares. These shares are not necessarily stapled for the purpose of the bill, so long as either shareholder may dispose of his interest in one corporation without disposing of his interest in the other.

The bill would not apply to U.S. corporations stapled to Puerto Rican corporations as of June 30, 1983 if the Puerto Rican corporation is described in section 957(c) of the Code (or would be described in that subsection if dividends from section 957(c) corporations were income described in section 957(c)), and if it does not own stock in any corporation that is not described in section 957(c). To qualify for this treatment, the stapled Puerto Rican corporation must also meet the activity test of section 957 (c)(2).

Effective Date

In general, this provision will take effect on the date of enactment of the bill. However, for interests stapled on or before June 30, 1983, the amendment will not apply until January 1, 1985. In addition, the bill will not apply to foreign corporations stapled to U.S. corporations on June 30, 1983, until January 1, 1987. A group of stapled. entities that included a REIT on June 30, 1983, will not be subject to the rules of the bill if all members of the group were stapled on that date.

Revenue Effect

The provision will reduce budget receipts by less than $5 million annually.

F. Miscellaneous Treasury Administrative Provisions

1. Simplification of Certain Reporting Requirements (sec. 461 of the bill)

Present Law

The Department of the Treasury is required to report to the Congress regarding specific statutory provisions on an annual or other periodic basis. The provisions affected by the bill are discussed below.

DISC.—The Treasury Department is required by statute to submit an annual report on the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code.[30] This report is due 15-1/2 months after the end of each calendar year.

International boycotts.—The Treasury Department is required by statute to submit an annual report on the international boycott provisions of the Internal Revenue Code.[31] This report is to set forth the number of boycott reports filed for taxable years ending with or within that year, the number of such reports on which the taxpayer indicated boycott participation or cooperation, and a detailed description of the manner in which the boycott provisions of the Code have been administered during that calendar year. The Secretary is to transmit this report as soon after the close of each calendar year as the data become available.

Possessions corporations.—The Committee reports on the Tax Reform Act of 1976 require an annual report to the House Committee on Ways and Means and the Senate Committee on Finance on possessions corporations. The Committee reports stated that "The Treasury is to submit an annual report . . . setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions."[32] The Committee reports indicated that these annual reports are to be submitted within 18 months following the close of each calendar year.

High income taxpayers.—The Tax Reform Act of 1976 requires the Department of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes.[33] The statute presently requires calculation of total income in the following three ways: (1) adjusted gross income (AGI) plus tax preference items (which are exclusions from gross income or deductions in arriving at AGI), (2) AGI less investment interest and expense (to the extent that it does not exceed investment income), and (3) AGI with both of these modifications. The statute also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits they used to avoid tax.

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[30] Sec. 506 of the Revenue Act of 1971, Public Law 92-178, imposes this requirement.

[31] Sec. 1067 of the Tax Reform Act of 1976, Public Law 94-455, imposes this requirement.

[32] H. Rep. No. 94-658, 94th Cong., 1st Sess. 259; S. Rep. No. 94-938, 94th Cong., 2d Sess. 282.

[33] Sec. 2123 of the Tax Reform Act of 1976, Public Law 94-455, imposes this requirement.

Reasons for Change

The committee believes that the Treasury reporting requirements can be lessened without diminishing the usefulness of information supplied in the reports. The committee understands that the Treasury will make current the statistics of income reports relating to foreign income.

Explanation of Provision

The bill modifies several of the statutory Treasury Department reporting requirements.

DISC.—The Secretary of the Treasury will be required to submit a report setting forth an analysis of the operation and effect of the DISC provisions for calendar 1981 and for each second calendar year thereafter. The DISC report will be due 27-1/2 months following the close of each such second year.

International boycotts.—The bill requires the Secretary to submit an international boycott report for every four-year period. The first four-year period will begin with calendar year 1982. The data required would be the data required under current law, for a four-year period rather than a one-year period. The report will be due as soon after the close of each four-year period as the data become available.

Possessions corporations.—The Secretary will be required to submit a report setting forth an analysis of the operation and effect of the possessions corporations provisions for calendar 1981 and for each second calendar year thereafter. The possessions corporations report will be due 24 months following the close of each such second year.

High income taxpayers.—The bill requires the Secretary of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes. Total income could be calculated and set forth by adding to adjusted gross income any tax preference items excluded from or deducted in arriving at AGI, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. The bill also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits that they used to avoid tax.

Effective Dates

The new rule for DISC reports and possessions reports applies to reports for calendar years after 1980. The new rule for high income taxpayer reports applies to information published after the date of enactment. The new rule for international boycott reports applies to reports for periods after December 31, 1981.

Revenue Effect

This provision will have no revenue effect.

2. Removal of $1 Million Limitation on Working Capital Fund (sec. 462 of the bill and sec. 322(a) of Title 31)

Present Law

Under present law, the Treasury Department's Working Capital Fund provides for the financing of centralized, Department-wide services such as printing procurement, reproduction, telephone, and teletype functions (31 U.S.C. 322(a)). The fund is limited to a capitalization of $1 million. This limitation was set in 1970 when the Fund was established.

Reasons for Change

The committee believes the ceiling on the Working Capital Fund is unnecessary and should be removed.

Explanation of Provision

Under the bill, the $1 million limit on the Working Capital Fund of the Department of Treasury is removed.

Effective Date

This provision will be effective upon enactment of the bill.

Revenue Effect

This provision will have a negligible revenue effect.

3. Increase in Limitation on Revolving Fund for Redemption of Real Property (sec. 463 of the bill and sec. 7810 of the Code)

Present Law

Under present law, if real property on which the United States has or claims a lien is sold to satisfy a lien prior to that of the United States, the Internal Revenue Service may redeem the property generally within 120 days of the sale date (sec. 7425). This redemption right is exercised, however, only when the Service concludes that the sale price of such real property is significantly below the fair market value and if the sale price does not provide sufficient receipts to cover the government's lien.

All expenses necessary for the redemption by the Service of such real property are chargeable to a revolving fund. The fund is repaid upon a subsequent sale of the property. Under present law, the authorization for this fund may not exceed $1 million. This figure was established in 1966. Because of increases in the numbers of taxpayer delinquencies, escalating real property values, and a greater frequency in foreclosures, the present $1 million authorization for the revolving fund is insufficient to provide for all those cases where redemption of real property sold to satisfy a lien prior to that of the United States would be prudent.

Reason for Change

The committee believes that the monetary interests of the United States would be better protected if additional funds were authorized for the revolving fund for the redemption of property.

Explanation of Provision

The authorization limitation on the real property redemption revolving fund will be increased to $10 million.

Effective Date

The provision will be effective upon enactment of the bill.

Revenue Effect

This provision will not have a direct revenue effect. If pursuant to the increased authorization, additional funds are appropriated for the revolving fund and redemption rights are exercised more frequently, revenues could be increased.

4. Removal of $1,000,000 Limitation Authority to Dispose of Obligations (sec. 464 of the bill and sec. 324(b) of Title 31)

Present Law

Under present law, the Secretary of the Treasury has special authority, outside of the context of the Federal Property and Administrative Services Act of 1949, to dispose of obligations acquired by the Secretary for the United States or transferred to the Secretary by an executive agency. The Secretary may also make arrangements to extend the maturity of such obligations. The Secretary is authorized to dispose or extend the maturity of obligations "in the way, in amounts, at prices, and on conditions the Secretary considers advisable and in the public interest."

The provision was enacted in 1945, as part of the Public Debt Act of 1945. It was designed, among other things, to allow for the expeditious disposition of obligations without the market disruption and loss that might be attendant on lengthy disposal procedures, including a three-month advertising requirement then applicable. Since its enactment in 1945, it has contained a limitation of $1,000,000 on the maximum par value of obligations of one issuer that could be held for such disposition. If no-par obligations are involved, the $1,000,000 limitation applies to the stated or book value of such obligations.

Reasons for Change

Because of inflation and changes in the capitalization of entities in which the United States has acquired an interest, the committee believes that the $1 million limitation is no longer appropriate. It has restricted the ability of the Secretary to obtain the best value for the United States in disposition transactions.

Explanation of Provision

The bill repeals the $1,000,000 limitation of the Secretary's special authority to dispose of obligations.

Effective Date

The provision will be effective on date of enactment.

Revenue Effect

The provision will have a negligible revenue effect.

5. Secretary of Treasury Authorized to Accept Gifts and Bequests (sec. 465 of the bill and sec. 322(a) of Title 31)

Present Law

At present, the Treasury Department has authority to accept voluntary services in connection with the sale of public debt obligations (31 U.S.C. 21). Also, the Department has joint authority with the General Services Administration to accept gifts for the purpose of reducing the national debt (31 U.S.C. 3113) and for defense purposes (50 U.S.C. 1151). However, the Secretary of the Treasury does not have general authority to accept gifts and bequests on a department-wide basis to carry out departmental functions. The Comptroller General has ruled that agencies may not accept gifts and bequests for assisting them in carrying out governmental functions in the absence of specific authorization (36 Comp. Gen. 268). At present, there are numerous statutes authorizing various agencies to accept gifts in connection with their operations, *e.g.*, the Department of Commerce (15 U.S.C. 1522), the Department of Transportation (49 U.S.C. 1657 (m)), and the Department of Housing and Urban Development (42 U.S.C. 3535(k)). In addition, department-wide gift authority is possessed by the Departments of Agriculture and State and numerous other agencies for the conduct of agency activities.

Reasons for Change

The committee believes that the Treasury Department should be authorized to accept departmental gifts in the same way as other departments are authorized.

Explanation of Provision

The bill authorizes the Secretary of the Treasury to accept gifts and bequests of property for the purpose of aiding or facilitating the work of the Department of Treasury. Gifts and bequests of money and the proceeds from sales of other property so received will be deposited in a separate fund of the Treasury to be disbursed upon the Secretary's order.

The Secretary annually must publicly disclose the source of the gifts and bequests and the purposes for which any expenditures are made.

Effective Date

The provision will be effective upon enactment.

Revenue Effect

The provision will have a negligible revenue effect.

6. Extension of time for Court Review of Jeopardy Assessment Where Prompt Service Not Made on United States (sec. 466 of the bill and sec. 7429 of the Code)

Present Law

Generally, the Internal Revenue Service may not assess any income tax without sending a written notice of deficiency allowing the taxpayer 90 days in which to petition the Tax Court for review of the Service's determination.

No assessment may be made until after the 90-day period has expired or, if a petition is filed, until after a decision of the Tax Court is final.

These deficiency procedures need not be followed, however, when the I.R.S. reasonably believes that collection of an alleged deficiency would be jeopardized by delay. In such a case, the Service may immediately assess and collect the tax (secs. 6851 and 6861).

In jeopardy assessment cases, the taxpayer is entitled to an expedited review by the Secretary, through the district director, of whether the determination of jeopardy was reasonable under the circumstances and whether the amount assessed and demanded was appropriate under the circumstances (sec. 7429). After review by the district director, the taxpayer is also entitled to a review by the appropriate United States District Court. Under present law, the District Court must decide whether the determination of jeopardy was reasonable under the circumstances and whether amount of the assessment was appropriate under the circumstances. This decision must be made within 20 days after an action by a taxpayer for review of the Secretary's determination is commenced. This action is a suit against the United States and, therefore, requires that the United States be given notice. However, neither the applicable statute (sec. 7429) nor the Federal Rules of Civil Procedure require service of notice of the action to be served on the United States within the 20-day period.

Reasons for Change

The committee wishes to assure adequate time for the United States to respond before a decision must be entered in any suit brought by a taxpayer for a review of a jeopardy action.

Explanation of Provision

Under the bill, if the District Court determines that proper service was not made on the United States within 5 days of the date on which the action is commenced, the 20-day period for action by the District Court will not begin to run until the day proper service was made on the United States.

Effective Date

This provision will apply to actions commenced after the date of enactment.

Revenue Effect

The provision will have a negligible revenue effect.

7. Extension of Period to Assess Unpaid Taxes (sec. 467 of the bill and sec. 6501 of the Code)

Present Law

Present law generally limits the period for assessing taxes to three years beginning with the date the return is filed or the due date of the return, whichever is later. This general rule is modified for fraudulent returns, returns involving a substantial omission of income and in several other appropriate circumstances. There is no provision, however, which permits extending the period for assessment solely for purposes of processing an amendment to an original return and assessing additional taxes due.

Reason for Change

Under present law it is very difficult for the Internal Revenue Service to assess additional tax reported on amended returns filed on, or just prior to, the expiration of the period for assessment of taxes on the original return. The committee's bill therefore extends the time for assessment of amounts shown on certain amended returns.

Explanation of Provision

Section 6501 is amended to provide that if a taxpayer amends an original return to show an increase in tax liability within 60 days of the expiration of the period for assessment of tax, the period for assessment will be extended solely to allow the IRS 60 days from the date the amendment is received to process the amendment and assess the additional tax shown thereon. This change will assure that additional tax due as reported by a taxpayer on an amended return may be assessed and collected.

Effective Date

The provision is effective for amended returns received after date of enactment of the bill.

Revenue Effect

This provision will increase revenues by less than $5 milion annually.

8. Lien on Assets of Financial Institutions for Unpaid Drafts (sec. 468 of the bill and sec. 6311(d) of the Code)

Present Law

Under present law (sec. 6311(b)(2)), if a certified, treasurer's or cashier's check received in payment of taxes is not duly paid, the United States has a lien upon all assets of the bank or trust company on which drawn. This rule also provides a lien against the assets of the issuer of a money order. The lien is a preferred claim and consequently permits the Service to treat such payments as the equivalent of cash for the purposes of releasing a Federal tax lien encumbering a taxpayer's property. The taxpayer retains ultimate liability if the IRS is unable to collect from the bank or trust company.

Reasons for Change

There have been many changes in the activities of financial institutions during the past few years. Mutual savings banks, credit unions and savings and loan associations generally provide checking account services that were not anticipated when the provisions of present law were enacted. In addition, these institutions may certify checks and issue instruments that are viewed by the general public as equivalent to the traditional cashier's check issued by a commercial bank, and should be so treated for purposes of collecting from the issuers.

Explanation of Provision

The bill extends the provision of section 6311(b)(2) to include guaranteed drafts of financial institutions other than banks and trust companies. It is expected that the regulations issued under this provision would define "financial institution" to include domestic building and loan associations, mutual savings banks, and credit unions.

Effective Date

This provision will be effective upon date of enactment.

Revenue Effect

This provision will have a negligible revenue effect.

9. Disclosure of Windfall Profit Tax to State Tax Agencies (sec. 469 of the bill and sec. 6103(d) of the Code)

Present Law

Present law (sec. 6103(d)(1)) authorizes the disclosure of returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52 and subchapter D of chapter 36 to the State tax agencies which are principally charged with the primary responsibility for the administration of State tax laws. Present law does not authorize the Service to disclose windfall profit tax (chapter 45) information to State tax agencies.

Reasons for Change

The provision will provide States with a means of verifying information reported by oil producers and purchasers, in compliance with State severance tax laws, with information provided by the producers and purchasers to the Internal Revenue Service with respect to the windfall profit tax.

Explanation of Provision

The bill adds the windfall profit tax to the list of tax returns and return information which the Internal Revenue Service may disclose to State tax agencies for purposes of administering State tax laws.

Effective Date

This provision will be effective on date of enactment.

Revenue Effect

This provision will have no revenue effect.

10. Provisions Relating to Distilled Spirits

a. Repeal of occupational tax on manufacturers of stills and condensers (sec. 470 of the bill and secs. 5101, 5105 and 5179 of the Code)

Present Law

Present law (sec. 5101) imposes an occupational tax of $55 per year on manufacturers of stills. In addition, a tax of $22 is imposed on each still (or condenser to be used in distilling) manufactured. An exemption from these taxes is provided for stills manufactured by a proprietor of a distilled spirits plant exclusively for use in the proprietor's plant.

Under present law, a manufacturer of stills is required to notify the Treasury Department, in writing, of the removal of a still, boiler, or other distilling vessel from the place of manufacture and the person and place to which it is being delivered (sec. 5105). The still (or other distilling apparatus) may be set up only upon receipt of a written permit from the Treasury. Further, every person having possession or control over a still is required to register with the Treasury immediately after setting up the still (sec. 5179). The registration must set forth the name and address of the owner and the location, capacity and purpose of the still.

Reasons for Change

The costs to administer the taxes on still manufacturers substantially outweigh the revenues derived from these taxes (less than $10,000 per year). The bill therefore repeals these taxes.

The committee has considered the notice requirement for removal of stills and other distilling apparatus and believes that this requirement serves a valid administrative purpose relating to the collection of alcohol taxes generally. However, in recognition of the costs to both the Treasury and private businesses of administering these provisions, the committee believes that the Treasury should be entitled to apply this requirement at its own discretion. Accordingly, the bill replaces the existing statutory notice requirement with a provision allowing the Treasury to require notice pursuant to regulations.

The committee understands that, because the excise tax liability for distilled spirits attaches upon production, the Treasury must be aware of the location of stills and other distilling apparatus in order to properly administer these taxes. The committee has therefore retained the mandatory requirement of registration immediately after setting up a still.

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Explanation of Provision

The bill repeals both the $55 per year occupational tax on manufacturers of stills and the additional $22 tax for each still.

The bill repeals the mandatory requirement of notice of manufacture and removal of a still and the requirement of permission prior to set up of a still. In their place, the bill provides that the Treasury Department may, pursuant to regulations, require manufacturers of stills, boilers, or other distilling vessels to give notice before removal of the facility. This notice (if required) would set forth the capacity of the facility, the time of removal, and the person by whom the facility is to be used. However, the bill retains the requirement of registration by the still user after setting up the facility.

Effective Date

The provision is effective on the first day of the first month beginning more than 90 days after the date of enactment.

Revenue Effect

The provision will reduce budget receipts by less than $1 million annually.

b. Return of taxes on spirits used for food or medicinal purposes (sec. 471 of the bill and sec. 5134 of the Code)

Present Law

Present law imposes an excise tax of $10.50 per proof gallon of distilled spirits (sec. 5001). The law provides for the return (drawback) of the major portion of taxes on distilled spirits used in the manufacture of food products, flavorings, or medicines which are unfit for beverage purposes (sec. 5134). A drawback is claimed by submission of a properly executed claim by a qualifying user of the spirits.

Taxpayers claiming a drawback of distilled spirits taxes are required to keep the necessary books and records to establish that the spirits were used for food, medicinal or other nonbeverage purposes (sec. 5132). Treasury regulations require that supporting data be maintained by the manufacturer, including quantitative formulae which must be filed prior to or at the time of manufacture (27 CFR Part 197.95). Failure to comply with these requirements results in a denial of the claim. For example, any deviation from a previously filed formula may result in denial of a substantial drawback claim.

Reasons for Change

The committee believes that failure to comply with various technical aspects of the drawback provisions should not result in denial of the taxpayer's claim. Accordingly, the bill provides that a penalty be imposed for such violations, in lieu of denying the claim. This is consistent with the treatment of other nonfraudulent regulatory violations under the Internal Revenue Code.

Explanation of Provision

The bill provides that the Treasury Department shall not deny a drawback claim because of failure to comply with laws or regulations, if it is established to the Department's satisfaction that the distilled spirits have been used for food, medicinal or other nonbeverage purposes. In lieu of denial, the claimant will be liable for a $1,000 penalty for each failure to comply with the applicable laws or regulations (unless it is shown that the failure was due to reasonable cause). The aggregate amount of the penalties may not exceed the amount of the taxpayer's claim.

The committee intends that, in instances where nonbeverage products deviate from previously filed formulas, the determination of a failure to comply with the regulations would be made with respect to each separate product reflected in a drawback claim. For example, if a manufacturer of two distinct flavors or extracts were to submit a drawback claim, and some portion of each flavor deviated from the previously filed formula, the claimant would be liable for a penalty of $2,000 (unless the failure to comply was due to reasonable cause).

Effective Date

The provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Revenue Effect

This provision will reduce revenues by less than $1 million annually.

c. Disclosure of alcohol fuel producers to administrators of State alcohol laws (sec. 472 of the bill and sec. 6103 of the Code)

Present Law

Present law (sec. 6103) prohibits the Treasury Department from disclosing individual tax return information (including the identity of taxpayers), without the taxpayer's consent, except under certain specified circumstances. In general, disclosure is permitted where necessary for the enforcement or administration of the tax laws (including tax legislation), in connection with criminal investigations, and in certain cases including an overriding public policy interest (e.g., disclosure to state child support enforcement agencies). Disclosure may also be made to other Federal agencies for certain specified purposes.

Under present law (sec. 6103(d)), tax return information may be disclosed to State agencies charged with responsibility for administration of State tax laws. Such disclosure may be only to the extent necessary for the administration of State tax laws.

The names and addresses of distillers who produce alcohol for fuel use qualify as tax return information under present law. Accordingly, this information may be disclosed only under the circumstances specified by the Code (e.g., to State tax agencies).

Reasons for Change

The committee believes that disclosure of the identity of alcohol fuel producers will be useful to State governments in monitoring the production of alcohol fuels. Such disclosure is consistent with the general Federal policy of encouraging the development and use of these fuels. However, the committee believes that this disclosure should be subject to reasonable safeguards to preserve the confidentiality of the information.

Explanation of Provision

The bill allows the Treasury Department to disclose the names, addresses, and business locations of persons producing alcohol for fuel use to State agencies (or their legal representatives) charged with responsibility for the administration of State alcohol laws. The information is to be disclosed solely for use in the administration of State alcohol laws.

The disclosure allowed by the bill is subject to the safeguards established by present law (sec. 6103(p)(4)) for disclosure to other Federal and State agencies. These safeguards are designed to preserve the confidentiality of information once it has been provided to another agency.[34]

Effective Date

The provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Revenue Effect

The provision will have no revenue effect.

d. Elimination of Government-supplied strip stamps for distilled spirits containers (sec. 473 of the bill and secs. 5205, 5604, and new sec. 5301(d) of the Code)

Present Law

Present law (sec. 5205) requires distilled spirits containers transported or sold in the United States to bear a stamp indicating that the Federal excise tax on the spirits has been paid. Strip stamps which satisfy this requirement are printed by the Bureau of Engraving and Printing at an estimated cost of $1.7 million per year and are distributed to distillers and bottlers free of charge.[35] Although regulations first effective in 1980[36] authorize the use of alternate methods of indicating payment of tax, most distillers have continued to use the Government-supplied strip stamps on distilled spirits containers.

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[34] Sec. 6103(p)(4) requires, *inter alia*, that an agency receiving return information must (1) establish and maintain a permanent system of standardized records with respect to requests for information made or received by the agency, (2) restrict access to tax return information to those who require it, and (3) provide such other safeguards as Treasury may deem appropriate. The agency is further required to report to the Treasury concerning its procedures for preserving confidentiality.

[35] U.S. General Accounting Office, "The Federal Government Can Save $1.7 Million Annually by Eliminating Strip Stamps" (GAO Report GGD-82-60, May 7, 1982).

[36] 27 CFR Part 19.663.

Government-supplied strip stamps must generally be broken in order to open a distilled spirits container. Thus, the stamps act as closure devices for the containers.

For many years, strip stamps were numbered and generally controlled by employees of the Treasury Department's Bureau of Alcohol, Tobacco, and Firearms. The stamps were applied after these employees had determined the appropriate tax and had been satisfied that the spirits had been bottled in conformance with Federal laws. However, the Distilled Spirits Tax Revision Act of 1979 (P.L. 96-39) significantly modified the determination of tax on distilled spirits. The new method of determining tax when spirits are withdrawn from bond eliminated the need for Federal employees to be present at distilled spirits plants to regulate operations and to determine the tax before bottling. Consequently, strip stamps are now provided to distillers and, in most cases, are placed on distilled spirits containers before the tax has been determined.

Reasons for Change

The committee understands that, pursuant to the Distilled Spirits Tax Revision Act of 1979, the Treasury Department is eliminating regular on-site supervision of distilled spirits plants and concentrating its effort on an audit-based approach to tax compliance. The committee further understands that, because strip stamps are now generally placed on distilled spirits containers before the tax is determined, the stamps no longer provide evidence of payment of the tax. For these reasons, and because of the costs of supplying the stamps, the bill provides that government-supplied strip stamps will be eliminated. However, to prevent tampering with the contents of distilled spirits containers, the committee bill requires that alternate closure devices be used.

Explanation of Provision

The bill repeals the strip stamps requirement for distilled spirits containers (sec. 5205) and associated penalty provisions (sec. 5604). However, the bill requires that distilled spirits containers, on determination of tax, must bear a closure or other device which is designed to require breaking in order to gain access to the contents of the container (new sec. 5301(d)). The provision applies to domestically produced and imported distilled spirits. Closure devices are not required for containers having a capacity in excess of one wine gallon.

Effective Date

These provisions are effective January 1, 1985. The committee intends that government-supplied strip stamps may be used only until that date.

Revenue Effect

The provision will have no effect on budget receipts.

G. Tax Court Provisions

1. Small Tax Cases (sec. 475 of the bill and sec. 7463 of the Code)

Present Law

Under present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted to practice before the Tax Court. In general, small tax cases are cases involving $5,000 or less for any one taxable year or period. Such proceedings are generally conducted in a more informal atmosphere, and the Court's opinion is final and may not be appealed.

Reasons for Change

The committee believes that Tax Court cases could be handled more expeditiously if the dollar limit on the cases in which the taxpayer may elect the small tax case procedures were raised, and if taxpayer representation in those cases were expanded.

Explanation of Provision

The bill permits taxpayers to be represented in the Tax Court in small tax cases by certified public accountants and enrolled agents who are authorized to practice before the I.R.S., regardless of whether such persons have been admitted to practice before the Tax Court by passing the Court's examination.

The bill raises the dollar limit in small tax cases to $10,000.

Effective Date

The provision will be effective on the date of enactment of the bill.

2. Survivor Annuities (sec. 476 of the bill and sec. 7448 of the Code)

Present Law

Under the survivors annuity plan for Tax Court judges, if a judge is survived by a spouse and a dependent child or children, an annuity equal to one-half the annuity of the surviving spouse (but not to exceed the lesser of $900 per year divided by the number of such children or $360 per year) is payable to each child. If a judge leaves no surviving spouse, but leaves a surviving dependent child or children, the annuity payable to each child is equal to the annuity to which a surviving spouse would have been entitled, but not to exceed $480 per year.

These maximum annuity amounts have not been changed since 1961, although the limits for annuities to surviving children of other Federal judges have been increased.

Reasons for Change

The committee believes that the annuities for surviving children of Tax Court judges should be increased to reflect cost of living changes since the limits were set.

Explanation of Provision

Under the bill, the maximum annuities receivable by surviving children of a deceased Tax Court judge in the case where the judge also leaves a surviving spouse will be increased from $900 per year per family ($360 per child) to $4,644 per year per family ($1,548 per child). The comparable amounts for surviving dependent children where the judge leaves no surviving spouse will also be increased to a maximum annuity not in excess of $5,580 per year per family, or $1,860 per child, whichever is less.

These maximum limits are equal to those currently in effect for other Federal judges.

Effective Date

These provisions will be effective for annuities payable for months after the date of enactment of the bill.

3. Assignment of Proceedings (sec. 477 of the bill and sec. 7456 of the Code)

Present Law

Present law (sec. 7456 (d)) provides that the Chief Judge of the Tax Court may assign to the Court's commissioners for hearing and decision any declaratory judgment proceeding, any small tax case proceeding, and any other proceeding where the amount in dispute does not exceed $5,000, subject to such review as the Court may provide.

Reasons for Change

The committee wishes to clarify that additional proceedings may be assigned to Commissioners so long as a Tax Court judge must enter the decision.

Explanation of Provision

A technical change is made to allow the Chief Judge of the Tax Court to assign any proceeding to a special trial judge for hearing and to write proposed opinions, subject to review and final decision by a Tax Court judge, regardless of the amount in issue. However, special trial judges will not be authorized to enter decisions in this latter category of cases.

Effective Date

The provision will be effective as if enacted as part of the Miscellaneous Revenue Act of 1982.

4. Special Trial Judges (sec. 478 of the bill and sec. 7456 of the Code)

Present Law

The Chief Judge of the Tax Court is authorized to appoint "commissioners" to hear small tax cases and declaratory judgment actions. The commissioners must proceed under rules promulgated by the Court.

Reasons for Change

The committee believes that the title of the Commissioners should be changed to "Special Trial Judge", to better describe their job position.

Explanation of Provision

The title of Tax Court "commissioner" will be changed to "special trial judge."

Effective Date

The provision will be effective on date of enactment of the bill.

5. Publicity of Tax Court Proceedings (sec. 479 of the bill and sec. 7461 of the Code)

Present Law

All reports of the Tax Court and all evidence received by the Court are open to public inspection, except that after its decision in a case has become final, the Court may permit the withdrawal of documents from the record or make such other disposition thereof as it deems advisable.

Rule 103(a) of the Tax Court's Rules of Practice and Procedure provides that the Court may make any order which justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense, including an order requiring that a deposition or other written materials be placed under seal, that a trade secret or other information not be disclosed or be disclosed only in a designated way, or that documents or information be filed in sealed envelopes to be opened only as directed by the Court.

Reasons for Change

The committee wishes to clarify that the Tax Court may prevent disclosure of confidential information.

Explanation of Provision

The bill clarifies that the Tax Court may take any action necessary to prevent the disclosure of trade secrets and other confidential information.

Effective Date

The provision will take effect on the date of enactment of the bill.

6. Retirement Age for Tax Court Judges (sec. 480 of the bill and sec. 7447(b) of the Code)

Present Law

Under present law, Tax Court judges must retire upon attaining the age of 70 years.

Reasons for Change

The committee believes that Tax Court judges should be subject to the same Federal policy regarding mandatory requirement as other Federal employees, and thus should not be required to retire upon attaining age 70.

Explanation of Provision

The bill provides that Tax Court judges will no longer be required to retire upon attaining age 70, but instead may retire at any time after attaining age 70.

Effective Date

The provision will become effective on date of enactment of the bill.

7. Revenue Effect

The provisions relating to the Tax Court will not have a revenue effect.

H. Simplification of Income Tax Credits (secs. 481-486 of the bill and new secs. 21-53 of the Code)

Present Law

Present law provides a series of nonrefundable income tax credits which are allowable to reduce a taxpayer's tax liability. The credits have been added to the Internal Revenue Code over the years on an ad hoc basis, and presently the various credits are allowable against tax in the chronological order they were added to the Code. This results in several effects which probably were not intended. For example, certain credits for which no carryover is provided may become unusable while a lower-numbered credit for which a carryover is provided is used up. If the order had been reversed, a different result would have occurred.

Differences exist in the manner the various business credits may be used to reduce tax liability. First, credit carryovers are usable in different chronological orders—the investment credits are used on an earliest year first (FIFO) basis, and the other credits are used on a current year first basis. Next, the tax liability limitations for the different business credits differ. The investment tax credit (other than the energy tax credit) may be used to reduce 100 percent of the first $25,000 of tax and 85 percent of the tax in excess of $25,000. The targeted jobs credit may be used against 90 percent of tax liability; the ESOP credit may reduce 100 percent of the first $25,000 of tax liability and 90 percent of the tax in excess of $25,000. The remaining business credits, including the energy tax credit, may reduce 100 percent of tax liability. In each case, tax liability means the income tax imposed reduced by lower numbered credits. Finally, the investment credit, targeted jobs credit, research activities credit, and ESOP credit have a 3-year carryback period whereas the alcohol fuels credit has no carryback period; these credits have a 15-year carryforward period.

Reasons for Change

The committee believes that the present income tax credit mechanism is complex and, at times, not rationally structured. The committee believes that the computations of these credits should be rationalized and simplified. This can be accomplished by allowing the personal income tax credits to be placed first in order, and by combining the business credits into one credit with uniform carryover and tax liability limitations. The committee also believes taxpayers should generally not be able to eliminate their entire tax liability by use of the credits which provide business incentives. However, the committee believes that the research credit is of such importance that it should not be restructured at this time.

The committee recognizes that the foreign tax credit is different in purpose and concept from the personal credits and the incentive credits, and should not be included in such a uniform credit.

Explanation of Provision

Under the bill, the personal income tax credits—the dependent care credit, credit for elderly and disabled, residential energy credit and political contribution credit—will be allowable against tax before all other credits. Next the foreign tax credit, credit for clinical testing of certain drugs, and fuel production credit will be allowable against tax under the conditions of present law.

The business income tax credits—the investment tax credit (both the regular and the energy credits), targeted jobs credit, alcohol fuels credit, and ESOP credit—will be combined into one general business credit. This credit will be allowable against 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability. Tax liability generally means the income tax imposed reduced by other nonrefundable credits. The credit will be used on a FIFO basis with a 3-year carryback and 15-year carryforward period. The research activities credit will continue to be allowed against 100 percent of a taxpayer's tax liability.

Effective Date

The provision will be effective for taxable years beginning after 1983. Credits earned in pre-1984 years will continue to be carried to post-1983 years under the substantive rules (apart from the tax liability limitations) under which they were earned. Likewise, credits earned in post-1983 years may be carried back to pre-1984 years, subject to the new tax liability limitation rules imposed by the bill.

Revenue Effect

The provision will increase revenues by $223 million in fiscal 1984, $456 million in fiscal 1985, $437 million in fiscal 1986, $401 million in fiscal 1982, and $202 million in fiscal 1988.

I. Miscellaneous Tax Provisions

1. Rollover of Certain Partial Distributions From Qualified Plans (sec. 491 of the bill and sec. 402(a) of the Code

Present Law

Under present law, an employee's benefits from or under a tax-qualified pension, profit-sharing, stock bonus plan, or a qualified annuity plan generally are includible in income when the benefits are distributed. If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to another qualified pension, etc., plan or an individual retirement account, annuity, or retirement bond (an IRA). If a rollover is made, tax is deferred on the portion of the distribution rolled over. Under present law, no rollover is permitted for a plan distribution that is not a total distribution.

Present law defines a qualifying rollover distribution as one or more distributions (1) within one taxable year of the employee on account of the termination of the plan or, in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions under the plan, (2) that constitute a lump-sum distribution, or (3) that constitute a distribution of accumulated deductible employee contributions.

Similar rules apply under present law to benefits under tax-sheltered annuity contracts. Consequently, a lump-sum distribution under a tax-sheltered annuity contract also may be rolled-over, tax-free, to another tax-sheltered annuity contract or to an IRA. Tax-sheltered annuity contracts may be purchased for employees by certain tax-exempt organizations or by public educational organizations.

A distribution is a lump-sum distribution only if it consists of the balance to the credit of the employee under the qualified pension, etc., plan or tax-sheltered annuity contract, is made within one taxable year of the recipient, and is made on account of the employee's attainment of age 59½, separation from service, or death. In the case of a self-employed individual, a lump-sum distribution may be paid on account of attainment of age 59½, death, or disability.

If an employer maintains more than one qualified pension, etc., plan, present law requires that all qualified pension, etc., plans of the employer of the same type (*e.g.*, all profit-sharing plans) generally must be aggregated for purposes of determining whether the balance to the credit of the employee has been distributed in a lump sum distribution. A special exception applies solely for purposes of the rollover provisions. Consequently, if an employer maintains two qualified pension plans, one of which is a defined benefit pension plan and one of which is a money purchase pension plan, and the balance to the credit of an employee in the money purchase pension plan is distributed, the balance to the credit of the employee under the defined benefit pension plan is not counted under the aggregation rules. In the case of a tax-sheltered annuity contract, the aggregation rules provide that all tax-sheltered annuity contracts purchased for an employee by one employer are treated as a single contract for purposes of determining the balance to the credit of the employee.

Under present law, if no part of a lump sum distribution from a qualified pension, etc., plan is rolled over, it may be accorded special 10-year income averaging.[37] Also, present law provides that if a lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation generally is not includible in gross income until the securities are sold or exchanged. This rule applies whether or not all or a portion of the distribution is rolled over to another qualified plan or to an IRA.

Reasons for Change

The Committee believes that tax-free rollover of partial distributions from qualified plans or tax-sheltered annuity contracts should be permitted, provided that favorable tax treatment (*i.e.*, 10-year income averaging or long-term capital gains treatment) is denied for subsequent distributions.

Explanation of Provision

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, etc., plan, qualified annuity plan, or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution would be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury. For purposes of determining whether a distribution is at least 50 percent of the balance to the credit of the employee under a qualified pension, etc., plan or a tax-sheltered annuity contract, amounts credited under similar other qualified plans or tax-sheltered annuity contracts of the same employer are counted.

As under present law, the rollover of a partial distribution must be made within 60 days after the date of the distribution. If the employee or surviving spouse of the employee elects partial distribution rollover treatment, no portion of the distribution may be rolled over to another qualified pension, etc., plan or a tax-sheltered annuity. In addition, no special treatment would be accorded to net unrealized appreciation of employer securities. Any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) would not be eligible for the special 10-year income averaging and long-term capital gain treatment accorded lump sum distributions. Similarly, if an employee elects partial distribution rollover treatment under a tax-sheltered annuity, a subsequent distribution under any other tax-sheltered annuity of the same employer would not be eligible for long-term capital gains treatment.

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[37] Alternatively, a part of the distribution may be accorded long-term capital gain treatment. Long-term capital gain treatment also may be available with respect to a qualifying rollover distribution under a qualified annuity plan or a tax-sheltered annuity contract.

In the case of a rollover of a partial distribution, the maximum amount rolled over may not exceed the portion of the distribution includible in gross income. Also, amounts in IRAs could not be rolled over to a qualified pension, etc., plan or to a tax-sheltered annuity contract if the balance in the IRA consists, in part, of a rollover of a partial distribution.

Effective Date

The provision will be effective for distributions made after December 31, 1983, in taxable years ending after that date.

Revenue Effect

This provision will have a negligible effect on revenues.

2. Treatment of Certain Related Party Transactions (sec. 492 of the bill and sec. 267 of the Code)

Present Law

Under present law, an accrual-basis taxpayer is denied a deduction for certain accrued expenses or interest owed to related persons who use the cash method of accounting (sec. 267(a)(2)). The disallowed interest and business expenses are those which are not paid to the related person within the taxable year in which the expenses accrue or within 2½ months thereafter. This provision prevents an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee is not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed under section 267(a) is permanently lost. It cannot be deducted at some subsequent time when payment is made.

Present law places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer, including a shareholder who owns at least 2 percent of the stock in the corporation. Thus, the corporation's deductions (which in the case of a subchapter S corporation are taken into account on the shareholders' returns) are allowed at the same time the income is recognized by the shareholder. Furthermore, no deductions are lost if payment is made after the 2½-month period expires. Present law does not provide a similar rule for payments between an accrual basis partnership and a cash basis partner, although present law requires that guaranteed payments made to a partner be includible in the partner's taxable year corresponding to the year the partnership deducted the payment (secs. 706(a) and 707(c)) (an accrual rule).

Finally, present law provides that no deduction is allowed for losses from sales or exchanges of property between related parties, including controlled partnerships (secs. 267(a)(1) and 707(b)(1)). Any gain recognized on a subsequent disposition of the property by the related party is reduced by the disallowed loss.

Reasons for Change

The committee believes that persons who are related should be required to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income. The failure to use the same accounting method with respect to one transaction involves unwarranted tax benefits, especially where payments are delayed for a long period of time, and in fact may never be paid.

The committee also believes that the present rules may lead to an unduly harsh result in certain circumstances where payment is delayed more than 2½ months while allowing too much of a tax advantage for payments made within 2½ months after the close of a taxable year. Finally, certain related parties, such as a partnership and its partners, should be made subject to the related party rules in order to prevent tax avoidance by the use of different accounting methods.

Explanation of Provision

Under the bill, an accrual-basis taxpayer will be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related cash-basis taxpayer. Thus, the accrual-basis taxpayer will be allowed to deduct business expenses or interest owed to a related cash-basis taxpayer when payment is made (whether or not paid within 2½ months after the close of the taxable year); in other words, the deduction by the payor will be allowed no earlier than when the corresponding income is recognized by the payee. This provision will apply to all deductible expenses (whether or not deductible under section 162, 163 or 212) the timing of which depends upon the taxpayer's method of accounting or upon the making of an election to expense an item. It will not apply, for example, to expenses such as the deductions for cost recovery or depreciation of an asset (other than an asset which is related to the performance (or nonperformance) of services by the payee).

The present-law rules relating to accruals by subchapter S corporations will be extended to accruals by partnerships to partners, as well as to accruals by partners to partnerships and shareholders to subchapter S corporations. Also, the 2-percent *de minimis* exception for shareholders of subchapter S corporations is eliminated. Thus, for example, a partnership will not be allowed to deduct accrued business expenses or interest owed to a cash-basis partner until the amounts are paid and are includible in the income of that partner. This cash basis rule will apply to any payment made to a partner holding (actually or constructively) any capital interest or profits interest in the partnership or to any person related to a partner (within the meaning of secs. 267(b) or 707(b)(1)). This rule would not apply, however, to guaranteed payments (within the meaning of sec. 707(c)) made to a partner because the present law accrual rule is continued. Also, this rule will apply to amounts accrued by an "upper tier" partnership (or a partner in the "upper-tier" partnership) which is a partner in a "lower-tier" partnership to partners of the "lower-tier" partnership or to persons related to these partners. Finally, it will apply to amounts accrued by partners (to other partners) on behalf of a partnership, such as those amounts which the payor partner is obligated to make under the terms of the partnership agreement.

To illustrate the foregoing, assume that a corporation owns a one percent profits interest in partnership X and a 51-percent capital and profits interest in partnership Y. Partnership X uses the accrual method of accounting and partnership Y uses the cash method. Under the bill, unpaid interest owed by X to Y cannot be deducted by X until paid to Y, because Y is related to a partner of X by reason of section 707(b)(1)(A). If, however, the corporation has only a 40-percent interest in Y and, therefore, is not related to Y under section 707(b)(1), then the new rule would not apply.[38]

Finally, the bill extends the loss disallowance and accrual provisions of section 267 (as well as other provisions of the Code applicable to related parties defined under section 267) to transactions between certain controlled corporations. For purposes of these loss disallowance and accrual provisions, corporations would be treated as related persons under the controlled corporation rules of section 1563, except that a 50-percent control test would be substituted for the 80-percent test. (These rules are not intended to overrule the consolidated return regulation rules where the controlled corporations file a consolidated return.) The section 267 rules also are extended to transactions between a partnership or subchapter S corporation and a regular corporation which are commonly controlled. Finally, related parties under the provisions of section 707(b) are treated as related for all purpose of the Code referring to section 267.

Effective Date

The provision relating to timing of accruals will apply to taxable years beginning after December 31, 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983 or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

The provisions expanding the coverage of the related party rules will apply with respect to transactions after September 29, 1983 (other than with respect to amounts paid or incurred pursuant to a contract binding on September 29, 1983, and at all times thereafter).

Revenue Effect

It is estimated that this provision will increase budget receipts by $59 million in 1984, $114 million in 1985, $185 million in 1986, $264 million in 1987, and $350 million in 1988.

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[38] See Treas. Reg. sec. 1-267(b)(1) for present law application of section 267 to partnerships.

3. Preferred Stock Eligible for Small Business Corporation Stock Treatment (sec. 493 of the bill and sec. 1244 of the Code)

Present Law

Under present law, gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is generally treated as capital gain or loss. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses may offset up to $3,000 of ordinary income.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which is disposed of at a loss. This special treatment is accorded only to individual shareholders to whom the stock was originally issued, and to individuals who are partners in a partnership at the time the partnership acquired the stock from an issuing small business corporation and who share in a loss sustained by the partnership on the section 1244 stock.

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to $50,000 ($100,000 in the case of married taxpayers filing a joint return).

For stock to qualify as section 1244 stock, the following requirements must be met: (1) the stock must be common stock; (2) the corporation issuing the stock must be a domestic corporation; (3) the equity capital of the corporation may not exceed $1,000,000; (4) the stock must be issued for money or other property, subject to certain exceptions; and (5) the corporation must be engaged in the active conduct of a trade or business.

Reasons for Change

The committee believes that to encourage new venture capital, an ordinary loss deduction should be available on preferred stock, as well as common stock, of small business corporations.

Explanation of Provision

Under the bill, the ordinary loss provisions of section 1244 would be extended to losses on preferred stock of small business corporations. All restrictions applicable under present law to losses on common stock would apply to losses on preferred stock.

Effective Date

The provision applies to stock issued after the date of enactment.

Revenue Effect

It is estimated that this provision will reduce revenues by less than $5 million annually.

4. Medical Expense Deduction for Certain Lodging (sec. 494 of the bill and sec. 213 of the Code)

Present Law

Individuals who itemize deductions may deduct expenses paid during the taxable year, not reimbursed by insurance or otherwise, for medical care of the taxpayer and the taxpayer's spouse and dependents, to the extent that such expenses exceed five percent of adjusted gross income (sec. 213). The term medical care is defined in the statute to include amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to such medical care; and (3) insurance covering medical care. The primary rationale for allowing an itemized deduction for medical expenses is that extraordinary medical costs reflect an economic hardship, beyond the taxpayer's control, which reduces the taxpayer's ability to pay Federal income tax.

Reasons for Change

The committee is aware of instances in which an individual must travel away from home to receive medical care. In many such cases, this is because specialized care for a particular disease is not available at home, or because better care is available elsewhere. The committee is also aware that in some cases, the patient is unable to travel alone and must be accompanied by another person (for example, the parent of a minor child).

In some instances, as in the case of some chemotherapy treatment for cancer patients, the treatment away from home can be given in a hospital or hospital-related facility on an outpatient basis, which generally is less expensive than treatment on an inpatient basis in a hospital. While under present law the expenses of a hospital stay are deductible, expenses of lodging incurred away from home during outpatient medical treatment are not eligible for the deduction. The committee believes that a medical expense deduction for lodging expenses should be allowed in appropriate cases.

The committee is concerned, however, that the new provision may be difficult for the Internal Revenue Service to administer. In particular circumstances, it may be difficult to distinguish between a trip that is primarily a vacation and a trip that is primarily for medical care. The committee believes that placing a per-diem cap on the amount that is deductible for away-from-home lodging will be useful in alleviating this concern.

Explanation of Provision

Under the bill, the definition of medical care set forth in section 213(d) is broadened to include amounts paid for lodging while away from home under circumstances in which such lodging is primarily for and essential to medical care provided by a physician in a licensed hospital (or in a medical care facility which is a hospital-related facility or the equivalent of a licensed hospital). Medical care facilities described in this section include out-patient clinics which provide substantial services similar to those provided by hospitals (e.g., the Mayo Clinic). The deduction is not allowed for amounts paid for lodging that is lavish or extravagant under the circumstances. Further, no deduction is allowed for any amount of lodging expenses if there is any significant element of personal pleasure, recreation, or vacation in the travel away from home.

The committee intends that a person accompanying the individual whose lodging expenses are deductible under the bill (e.g., a parent accompanying a dependent child) may deduct lodging expenses if that person's transportation expenses for the trip are deductible as medical expenses under present law.

The amount of the deduction is subject to a limitation of $50 per night for each eligible person. Thus, if a parent accompanies a dependent child on a trip away from home for medical treatment which satisfies requirements of the bill, the parent could deduct up to a total of $100 per day for lodging expenses.

The bill does not allow a deduction for any expenses, such as food, other than the cost of lodging.

Effective Date

The provision applies to taxable years beginning after December 31, 1983.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $1 million in fiscal year 1984; $7 million in 1985; $10 million in 1986; $10 million in 1987; and $11 million in 1988.

5. Study of simplified tax on gross income (sec. 495 of the bill)

The bill provides that the Secretary of Treasury shall submit to the Congress, within 6 months of the enactment of this bill, a report on a study of the advisability of replacing the current income tax system (individual and/or corporate) with a simplified gross income tax. The study should take into account the following factors: (1) protecting the economically disadvantaged; (2) reducing administrative complexity; (3) reducing paperwork, auditing requirements, tax evasion, and expediting the resolution of taxpayer-government disputes; (4) increasing economic incentives for capital formation and productivity; (5) removing economic disincentives to employment; and (6) excluding certain items (such as social security benefits) from gross income.

J. Repeal of Certain Obsolete Provisions (Deadwood)

1. Termination of Rules Relating to Qualified Bond Purchase Plans and Retirement Bonds (sec. 497 of the bill and secs. 405 and 409 of the Code)

Present Law

Qualified bond purchase plans

Under present law, a bond purchase plan maintained by an employer and funded through the purchase of certain Federal bonds is a qualified plan if it meets specified requirements.[39] Under the Code, the bonds must be issued in the names of the individual employees (including self-employed individuals) on whose behalf they are purchased and must be nontransferable. The terms of the bonds provide for payment of interest, or investment yield, only upon redemption and provide for cessation of interest accruals, or investment yield, not later than five years after the death of the individual in whose name the bonds are purchased. Moreover, no amounts are included in an individual's gross income until the bonds are redeemed, which cannot occur until the named individual dies, becomes disabled, or attains age 59½.

The income portions of the proceeds of the redemption of bonds purchased under qualified bond purchase plans may be rolled over, tax-free, to an individual retirement account or annuity (an IRA), if the rollover is made within 60 days after the individual receives the proceeds of the redemption. If no rollover is made, the income portion of the redemption proceeds are includible in gross income. The income is not eligible for the long-term capital gains or 10-year income averaging treatment available for certain lump-sum distributions from tax-qualified pension, profit-sharing, or stock bonus plans. The bond are eligible, however, for certain estate tax and gift tax exclusions provided to tax-qualified plans.[40]

Individual retirement bonds

Under present law, an individual is allowed an annual deduction for contributions to purchase a qualified retirement bond.[41] The deduction is generally limited to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual). A qualified retirement bond is a bond issued under the Second Liberty Bond Act that accumulates interest until the time of redemption. The bonds are issued in the name of the individual

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[39] Sec. 405(a)(1). The plan must meet the requirements of section 401(a) relating to coverage and discrimination (sec. 401(a)(3), (4), (5) and (6)), vesting (sec. 401(a)(7), (8), and (9)), limitations (401(a)(16)), and may be subject to rules relating to distributions and self-employed individuals (sec. 401(a)(9) and (10)).

[40] Treas. Reg. secs. 20.2039-2(b) and 25.2517-1(b).

[41] Sec. 219(a).

(the registered owner) on whose behalf they are purchased and are not transferable.

When the bonds are redeemed, the full proceeds of the bonds, including interest earned, are included in the individual's gross income unless the proceeds are rolled over to an IRA.[42] If a bond is redeemed before the registered owner attains age 59½, has died, or has become disabled, a 10-percent additional income tax is imposed on the redemption proceeds. No deduction is allowed with respect to a bond that is redeemed within 12 months of the date of purchase and the proceeds of such a bond are not includible in gross income.

A qualified retirement bond ceases to bear interest in the year in which the registered owner attains age 70½ and the value of the bond is includible in the registered owner's gross income in that year, whether or not the bond is redeemed. If the registered owner dies before age 70½ or before the bond is redeemed, the bond ceases to bear interest five years after the registered owner's death or the date the registered owner would have attained age 70½, if earlier.

Redemption proceeds from qualified retirement bonds are eligible for tax-free rollovers to individual retirement accounts or annuities. Additionally, the bonds are eligible for certain estate tax and gift tax exclusions.[43]

Termination of sales

In a news release dated April 27, 1982, the Treasury Department announced that sales of bonds for qualified bond purchase plans and of individual retirement bonds would be terminated effective April 30, 1982. The Treasury Department indicated that sales of the bonds in recent months had been negligible. Bonds issued prior to April 30, 1982, continue to be subject to the terms and conditions in effect when they were issued.

Reasons for Change

Because new bonds cannot be purchased, the retirement plans of present bondholders may be disrupted unless the proceeds of the bonds can be reinvested in other retirement arrangements. The committee believes it is appropriate to permit bonds purchased under qualified bond purchase plans to be redeemed before the registered owner attains age 59½. In addition, in order to provide greater investment flexibility to a bondholder (under a qualified bond purchase plan) who also participates in a qualified pension, etc., plan, the committee believes that the rollover of redemption proceeds to a qualified pension, etc., plan should be permitted.

Explanation of Provision

The bill repeals sections 405 and 409 of the Internal Revenue Code, relating to qualified bond purchase plans and individual retirement bonds. Notwithstanding the rules of section 405 (as in effect before repeal) and the terms of any bond issued under a qualified bond purchase plan, the bill permits an individual to redeem a bond at any time even though the individual has not attained age 59½.

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[42] Sec. 409.
[43] Secs. 2039 and 2517(a).

In addition, the bill provides that the redemption proceeds of bonds provided under a qualified bond purchase plan may be rolled over, tax-free, to a qualified pension, etc., plan. If such a rollover is made, however, the rollover amounts (1) must be subject to separate accounting under the recipient plan, and (2) are not eligible for capital gain or 10-year income averaging treatment, or the special treatment of net unrealized appreciation from employer securities.

Effective Date

The provision generally will be effective for obligations issued after December 31, 1983.

The provision relating to rollovers will be effective with respect to redemptions made after the date of enactment.

Revenue Effect

This provision will have no revenue effect.

2. Repeal of Section 1251 (relating to gains from disposition of certain property used in farming) (sec. 498 of the bill and sec. 1251 of the Code)

Present Law

Section 1251 was enacted in 1969 to prevent certain high income taxpayers from using farm losses to defer their non-farm income and then later obtaining capital gains on the disposition of their farm property. The Tax Reform Act of 1976 terminated these provisions with respect to farm losses incurred after 1975.

Reasons for Change

The committee believes that section 1251 should be repealed as deadwood since it no longer serves a meaningful function.

Explanation of Provision

The bill repeals section 1251, as deadwood.

Effective Date

The repeal of section 1251 will be effective for taxable years beginning after 1983.

Revenue Effect

This provision will have no revenue effect.

TITLE V—FRINGE BENEFITS PROVISIONS

A. Present Law

General rules

The Internal Revenue Code defines gross income for purposes of the Federal income tax as including "all income from whatever source derived," and specifies that it includes "compensation for services" (sec. 61). Treasury regulations provide that gross income includes compensation for services paid other than in money (Reg. sec. 1.61-1(a)). Further, the U.S. Supreme Court has stated that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[1]

The social security and unemployment insurance payroll taxes (FICA and FUTA, respectively) and income tax withholding apply to "wages," defined in the statutes as all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash (secs. 3121(a), 3306(b) and 3401(a)). The railroad retirement tax (RRTA) applies to any form of money remuneration (sec. 3231(e)). Regulations applicable to these statutes specify that the value of any noncash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item (see, e.g., Reg. sec. 31.3121(a)-1(e)).

Certain employee benefits, such as health plan benefits, are excluded by statute from gross income and wages. Nontaxable benefits offered under a plan which offers a choice between taxable and nontaxable benefits (a "cafeteria plan") may be excluded from gross income if certain conditions are met (sec. 125).

Moratorium on issuance of regulations

In 1975, the Treasury Department issued a discussion draft of proposed regulations which contained a number of rules for determining whether various nonstatutory fringe benefits constitute taxable compensation.[2] Public Law 95–427, enacted in 1978, prohibited the Treasury Department from issuing, prior to 1980, final regulations under section 61 of the Internal Revenue Code relating to the income tax treatment of fringe benefits. That statute further prohibited Treasury from proposing regulations relating to the treatment of fringe benefits under section 61 which would be effective prior to 1980.

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[1] *Comm'r* v. *Smith*, 324 U.S. 177, 181 (1945). Similarly, the Court has stated: "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted" (*Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429–30 (1955)).

[2] 40 Fed. Reg. 4118 (Sept. 5, 1975). The discussion draft was later withdrawn (41 Fed. Reg. 5634, Dec. 28, 1976).On January 15, 1981, the Treasury Department forwarded to the Committee on Ways and Means a revised discussion draft of proposed regulations on the tax treatment of fringe benefits. This discussion draft was not reviewed by the Secretary of the Treasury and was not published in the Federal Register. The discussion draft was reprinted in various publications, including Bureau of National Affairs, Daily Executive Report (Jan. 16, 1981), at p. J–14.

Public Law 96-167, enacted in 1979, extended the moratorium on issuance of fringe benefit regulations through May 31, 1981. That extension prohibited the Treasury Department from issuing, prior to June 1, 1981, final regulations under section 61 relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to June 1, 1981.

The Economic Recovery Tax Act of 1981 (Public Law 97-34) extended the moratorium on issuance of fringe benefit regulations through December 31, 1983. Under the 1981 Act, the Treasury Department is prohibited from issuing, prior to January 1, 1984, final regulations under section 61 relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 are to be proposed which would be effective prior to January 1, 1984.

B. Reasons for Change

In providing statutory rules for exclusion of certain fringe benefits for income and payroll tax purposes, the committee has attempted to strike a balance between two competing objectives.

First, the committee is aware that in many industries, employees may receive, either free or at a discount, goods and services which the employer sells to the general public. In many cases, these practices are long established, and have been treated by employers, employees, and the IRS as not giving rise to taxable income. Although employees may receive an economic benefit from the availability of these free or discounted goods or services, employers often have valid business reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products which they sell to the public. For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing which it seeks to sell to the public. In addition, the fact that the selection of goods and services available from a particular employer usually is restricted makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees, for the income employees realize from obtaining free or reduced-cost goods or services. The committee believes, therefore, that many present practices under which employers may provide to a broad group of employees, either free or at a discount, the products and services which the employer sells or provides to the public do not serve merely to replace cash compensation. These reasons support the committee's decision to codify the ability of employers to continue these practices without imposition of income or payroll taxes.

The second objective of the committee's bill is to set forth clear boundaries for the provision of tax-free benefits. Because of the moratorium on the issuance of fringe benefit regulations, the Treasury Department has been precluded from clarifying the tax treatment of many of the forms of noncash compensation commonly in use. As a result, the administrators of the tax law have not had clear guidelines in this area, and hence taxpayers in identical situations have been treated differently. The inequities, confusion, and administrative difficulties for businesses, employees, and the IRS resulting from this situation have increased substantially in recent years. The committee believes that it is unacceptable to allow these conditions—which have existed since 1978—to continue any longer.

In addition, the committee is concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by using a medium other than cash, new practices will emerge that could shrink the income tax base significantly, and further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash. A shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security system above and beyond the adverse projections which the Congress recently addressed in the Social Security Amendments of 1983. Finally, an unrestrained expansion of noncash compensation would increase inequities among employees in different types of businesses, and among employers as well.

The nondiscrimination rule is an important common thread among the types of fringe benefits which are excluded under the bill from income and employment taxes. Under the bill, most fringe benefits may be made available tax-free to officers, owners, or highly compensated employees only if the benefits are also provided on substantially equal terms to other employees. The committee believes that it would be fundamentally unfair to provide tax-free treatment for economic benefits that are furnished only to highly paid executives. Further, where benefits are limited to the highly paid, it is more likely that the benefit is being provided so that those who control the business can receive compensation in a nontaxable form; in that situation, the reasons stated above for allowing tax-free treatment would not be applicable. Also, if highly paid executives could receive free from taxation economic benefits that are denied to lower-paid employees, while the latter are compensated only in fully taxable cash, the committee is concerned that this situation would exacerbate problems of noncompliance among taxpayers. In this regard, some commentators argue that the current situation—in which the lack of clear rules for the tax treatment of nonstatutory fringe benefits encourages the nonreporting of many types of compensatory benefits—has led to nonreporting of types of cash income which are clearly taxable under present-law rules, such as interest and dividends.

In summary, the committee believes that by providing rules which essentially codify many present practices under which employers provide their own products and services tax-free to a broad group of employees, and by ending the uncertainties arising from a moratorium on the Treasury Department's ability to clarify the tax treatment of these benefits, the bill substantially improves the equity and administration of the tax system.

C. Explanation of Provisions

1. Overview

Under the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RRTA.

The excluded fringe benefits are those benefits that qualify under one of the following five categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, and (5) a qualified tuition reduction. Special rules apply with respect to certain parking or eating facilities provided to employees, on-premises athletic facilities, and demonstration use of an employer-provided car by auto salespersons. Some of the exclusions under the bill apply to benefits provided to the spouse and dependent children of a current employee, to former employees who separated from service because of retirement or disability (and their spouses and dependent children), and to the widow(er) of a deceased employee (and the dependent children of deceased employees).

In the case of a no-additional-cost service, a qualified employee discount, employee parking or eating facilities, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefit is made available to employees on a basis which does not discriminate in favor of officers, owners, or highly compensated employees.

Any fringe benefit that does not qualify for exclusion under the bill (for example, free or discounted goods or services which are limited to corporate officers) and that is not excluded under another statutory fringe benefit provision of the Code is taxable to the recipient under Code sections 61 and 83, and is includible in wages for employment tax purposes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally take effect on January 1, 1984, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1984.

2. No-additional-cost Service (Sec. 502 of the bill and new Code sec. 132(b))

General rule

Under this category, the entire value of any no-additional-cost service provided by an employer to an employee for the use of the employee (or of the employee's spouse or dependent children) is excluded for income and employment tax purposes. However, the exclusion applies only if the service is available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill).

To qualify under this exclusion, the employer must incur no substantial additional cost in providing the service to the employee, computed without regard to any amounts paid by the employee for the service. For this purpose, the term cost includes any revenue forgone because the service is furnished to the employee rather than to a nonemployee.[3] In addition, the service provided to the employee must be of the type which the employer provides to nonemployee customers in the ordinary course of the line of business of the employer in which the employee is performing services.

Generally, situations in which employers incur no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity which otherwise would have remained unused because nonemployee customers would not have purchased it. Thus, employers that furnish airline, railroad, or subway seats or hotel rooms to employees working in those lines of business in such a way that nonemployee customers are not displaced, and telephone companies that provide telephone service to employees within existing capacity, incur no substantial additional cost in the provision of these services to employees, as this term is used in the bill.[4]

Line of business limitation

To be excluded under this category, a service must be the same type of service which is sold to the public in the ordinary course of the line of business of the employer in which the employee works. (Thus, types of services most of the employer's production of which are provided or sold to the employer's employees do not qualify for this exclusion.) For purposes of this limitation, a single employer is treated as consisting of more than one line of business if, after aggregating businesses under common control (see "definition of employer," below), the products or services the employer sells to nonemployee customers fall into more than one industry group.

In providing guidance as to the treatment of an employer as consisting of separate lines of business for this purpose, Treasury regulations may take into account the business segments into which corporations divide themselves for financial reporting purposes. Also, Treasury regulations may refer to the Standard Industrial Classifications used for other governmental purposes.

Under this limitation, for example, an employer which provides airline services and hotel services to the general public is considered to consist of two separate lines of business. As a consequence, the employees of the airline business of the employer may not exclude the value of free hotel rooms provided by the hotel business of the employer, and vice versa. The purpose of the line of business limitation is to avoid, to the extent possible, the competitive imbalances and inequities which would result from giving the employees of a conglomerate or other large employer with several lines of business a greater variety of tax-free benefits than could be given to the employees of a small employer with only one line of business. Thus, small businesses will not be disadvantaged in their ability to compete with large businesses providing the same goods or services, and employees of small business will not be disadvantaged, in comparison to employees of multifaceted businesses, in terms of receiving tax-free economic benefits.

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[3] For the purpose of determining whether any revenue is forgone, it shall be assumed by the Treasury Department that the employee would not have purchased the service unless it were available to the employee at a below-market price.

[4] The employer does incur substantial additional cost (and hence the exclusion is not available) if a substantial amount of time is spent by employees in providing a service for other employees, as contrasted with the no-additional-cost situation in which the services provided to the employee (e.g., the in-flight services provided to an airline employee traveling on a standby basis) are merely incidental to services provided to nonemployee customers.

If an employee provides services that directly benefit more than one line of business of the employer, then the individual is treated as performing services in all such lines of business. Thus, for example, the chief executive officer, payroll department employees, and similar "headquarters" employees may exclude the value of no-additional-cost services provided by either the airline or hotel lines of business of the employer if they provide services which directly benefit both those lines of business.

Reciprocal arrangements

Under the bill, the employees of one employer are allowed the no-additional-cost service exclusion for services provided by an unrelated employer (i.e., another employer not under common control) only if the services provided to the employee are the same type of services as provided to nonemployee customers by both the line of business (of the first employer) in which the employee works and the line of business (of the other employer) in which the services are provided to the employee. In addition, both employers must be parties to a written reciprocal agreement under which the employees of each such line of business may receive the service from the other employer,[5] and neither employer may incur any substantial additional cost (including forgone revenue or payments to the other employer) in providing such service or pursuant to such agreement.

The criteria for determining whether two unrelated employers are providing the same type of service are the same as described above (under "line of business limitation") for determining the composition of the distinct lines of business comprised by a single employer. Thus, for example, the exclusion is available if two unrelated airlines provide free standby flights to each other's airline employees, but is not available to a hotel's employees if they receive free standby flights from an airline line of business (whether the airline is operated by the employees' employer or another employer).

Definition of employee

The bill provides that, with respect to a line of business of an employer, the term employee means (1) an individual who is currently employed by the employer in that line of business; (2) an individual who separated from service with the employer in that line of business by reason of retirement or disability; and (3) a widow or widower of an individual who died while employed by the employer in that line of business or of an individual who had separated from service with the employer in that line of business by reason of retirement or disability. The bill also provides that any use (e.g., of a standby airline flight) by the spouse or a dependent child of the employee (as so defined) is to be treated as use by the employee.[6] These definitions are relevant both for purposes of eligibility for the exclusion under the bill and for purposes of defining nonemployee customers.

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[5] Because businesses under common control are considered to be one employer (see "definition of employer," below), employees of one such commonly controlled business are eligible for the exclusion without need for a written agreement with the other commonly controlled business(es); however, the same-line-of-business test still applies in such cases.

Examples

As an illustration of the no-additional-cost service category of excludable benefits, assume that a corporation which operates an airline as its only line of business provides all of its employees (and their spouses and dependent children) with free travel, on the same terms to all employees, as stand-by passengers on the employer airline if the space taken on the flight has not been sold to the public shortly before departure time. In such a case, the entire fair market value of the free travel is excluded under the no-additional-cost service rule in the bill. This conclusion follows because the service provided by the employer to its employees who work in the employer's airline line of business is the same as that sold to the general public (airline flights), the service is provided at no substantial additional cost to the employer (the seat would have been unsold to nonemployees if the employee had not taken the trip),[7] and the eligibility terms satisfy the nondiscrimination rules of the bill since all employees are eligible for the benefit on the same terms.

This exclusion also applies where employees of the airline line of business of an employer receive free stand-by flights from the airline line of business of another employer through a written reciprocal agreement, if the benefit to the employee would have been excluded under this provision of the bill had it been provided in the same manner by the employee's employer. Thus, for example, the free flights furnished by the other employer must be available to the employees of the first employer on the same nondiscriminatory basis as required for the exclusion when furnished by the first employer, and neither employer may incur any substantial cost (including forgone revenue or any payment from one employer to the other) in providing the service or pursuant to the agreement.

Another example of a no-additional-cost service is the provision of utility services to the employees of the utility where there is excess capacity, such as the provision by a telephone company of free or reduced-cost telephone service to its employees.[8] Because the phone lines, switching capacity, and other overhead already exist, the telephone calls which employees may make without charge or at a reduced price impose no substantial additional cost on the employer. Thus, assuming the telephone service is provided to employees on a nondiscriminatory basis, the requirements of this exclusion category are met, and the value of the service is excluded from gross income and wages.

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[6] For this purpose, dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee who is a dependent of the employee or both of whose parents have died. A child of divorced, etc., parents to whom section 152(e) applies is treated as a dependent of both parents.

[7] Neither the provision of meals and refreshments to a passenger, nor any extra fuel consumption attributable to the weight of an additional passenger, is considered a substantial additional cost.

[8] Local telephone service and long-distance telephone service are to be considered the same line of business.

Under the bill, the exclusion for no-additional-cost service is not available, for example, to employees in the hotel line of business of a corporation for receipt of free stand-by travel on an airline operated by the same corporation, or to employees of a consumer goods manufacturer who travel for personal purposes on a company plane (even if the plane is otherwise making a trip on company business). In each of these cases, even assuming that there were no substantial additional cost to the employer in providing the service on a space-available basis, the service is not the same type generally provided to the general public in the specific line of business of the employer in which the employee-recipient works. Accordingly, the requirements of the no-additional-cost exclusion are not satisfied.

3. Qualified Employee Discount (Sec. 502 of the bill and new Code sec. 132(c))

General rule

Under the bill, certain employee discounts[9] allowed from the selling price of qualified goods or services of the employer are excluded for income and employment tax purposes, but only if the discounts are available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill). The exclusion applies whether the qualified employee discount is provided through a reduction in price or a cash rebate.

The exclusion is not available for discounts on any personal property (tangible or intangible) of a kind commonly held for investment or for discounts on any real property. Thus, for example, the exclusion does not apply to discounts on any employee purchases of securities, gold coins, residential or commercial real estate, or interests in mineral-producing property (regardless of whether a particular purchase is made for investment purposes). This limitation is provided because the committee does not believe that favorable tax treatment should be provided when noncash compensation is provided in the form of property which the employee could typically resell at close to the same price at which the employer sells the property to its nonemployee customers. Under the discount exclusion of the bill, an employee of a brokerage house may purchase stock and receive an excludable discount on a commission (subject to the 20-percent limitation discussed below for discounts on services). However, any discount allowed on the price of the stock itself is not eligible for the discount exclusion.

Line of business limitation

To qualify under this exclusion, the goods or services on which the discount is available must be those which are offered for sale by the employer to nonemployee customers in the ordinary course of the employer's line of business in which the employee works.

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[9] The term "employee discount" is defined in the bill as the amount by which the price at which the good or service is provided to the employee by the employer is less than the price at which such good or service is being offered by the employer to customers who are not employees.

(Thus, types of goods or services most of the employer's production of which are provided or sold to the employer's employees do not qualify for this exclusion.) The rules for treatment of a single employer as consisting of more than one line of business are the same as those described above in connection with the exclusion for a no-additional-cost service. However, the discount exclusion is not available for goods or services provided by another employer, whether or not a reciprocal agreement exists, except where commonly controlled businesses are treated as one employer (see "definition of employer," below).

For example, merchandise held for sale in the retail department store line of business of a firm is eligible for the discount exclusion if purchased at a discount by an employee of the firm who works in that line of business. Similarly, an employee who works for a manufacturer assembling appliances is eligible for the discount exclusion if the employee purchases the assembled appliances from the manufacturer-employer at a discount.

On the other hand, if an employee works for a company that consists of more than one line of business, such as a company consisting of a retail department store business, a hotel business, and an electrical component manufacturing business, an employee is eligible for the discount exclusion only for merchandise or services offered to customers in the ordinary course of business in the particular line of business in which the employee works. This is the case regardless of whether the employer makes discounts available to the employees in the other two lines of business. Thus, in this example, employees of the hotel business or of the electrical component manufacturing business are not eligible for the discount exclusion if these employees purchase merchandise at a discount from the employer's department store. However, employees of units of the employer that provide repair or financing services with respect to, or that sell by catalog, retail merchandise are considered as providing services in the retail merchandise line of business and hence are eligible for excludable discounts on merchandise items.

A grandfather rule under the bill relaxes the line of business limitation in certain existing situations. If (1) on October 5, 1983, the employees of one member ("the first member") of an affiliated group (as defined in section 1504) were entitled to employee discounts at retail department stores operated by another member ("the second member") of the affiliated group, and (2) in the year for which the income and employment tax determination is being made, most of the sales of the affiliated group are attributable to the operation of retail department stores, then, for purposes of the exclusion for qualified employee discounts, the first member of the affiliated group is to be treated as engaged in the same line of business as the second member (the operator of the department stores). Thus, the employees of the first member may exclude qualified discounts received at the retail department stores operated by the second member. This rule does not operate in the reverse direction, however; that is, the employees of the department stores may not exclude any discounts received on property or services offered by the other member of the affiliated group, whether or not such discounts were allowed on October 5, 1983.

Definition of employee

The bill provides that, with respect to a line of business of an employer, the term employee means (1) an individual who is currently employed by the employer in that line of business; (2) an individual who separated from service with the employer in that line of business by reason of retirement or disability; and (3) a widow or widower of an individual who died while employed by the employer in that line of business or of an individual who had separated from service with the employer in that line of business by reason of retirement or disability. The bill also provides that any use (e.g., of discounted goods) by the spouse or a dependent child of the employee (as so defined) is to be treated as use by the employee.[10] These definitions are relevant both for purposes of eligibility for the exclusion under the bill and for purposes of defining nonemployee customers.

Amount of exclusion

General rule.—Under the bill, an employee discount is excluded only up to a specified limit. In the case of merchandise, the excludable amount of the discount is limited to the selling price of the merchandise, multiplied by the employer's gross profit percentage. The discount exclusion for a service may not exceed 20 percent of the selling price, regardless of the actual gross profit percentage.

Merchandise.—In the case of merchandise, the excludable amount of the discount may not exceed the selling price of the merchandise, multiplied by the employer's gross profit percentage. For this purpose, the employer's gross profit percentage for a period means the excess of the aggregate sales price for the period of merchandise sold by the employer in the relevant line of business over the aggregate cost of such merchandise to the employer, then divided by the aggregate sales price.

For example, if total sales of such merchandise during a year were $1,000,000 and the employer's cost for the merchandise was $600,000, then the gross profit percentage for the year is 40 percent ($1,000,000 minus $600,000 equals 40 percent of $1,000,000). Thus, an employee discount with respect to such merchandise is excluded from income to the extent it does not exceed 40 percent of the selling price of the merchandise to nonemployee customers. If in this case the discount allowed to the employee exceeds 40 percent (for example, 50 percent), the excess discount on a purchase (10 percent in the example) is included in the employee's gross income.[11]

For the purposes of determining the employer's profit percentage, cost is to be computed by the employer in the same manner as it is for computing the employer's Federal income tax liability, under the inventory rules in Code section 471 and the regulations thereunder. Thus, for example, a retailer is to use the "retail method" of pricing inventories under Treas. Reg. sec. 1.471-8 in computing cost for purposes of the gross profit percentage discount limitation if that is the method used by the employer to value inventories for income tax purposes.

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[10] For this purpose, dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee who is a dependent of the employee or both of whose parents have died. A child of divorced, etc., parents to whom section 152(e) applies is treated as a dependent of both parents.

[11] This result occurs because the amount included in gross income as gross income attributable to a discount sale, under section 61, is the difference between fair market value and the price the employee pays for the merchandise. Since the fair market value of merchandise when sold to employees is the price at which the merchandise is being offered by the employer to customers who are not employees, the 50-percent discount in the example is included in gross income. Under the bill, a discount of 40 percent is excluded from gross income. The net result is that 10 percent of the selling price is included in the employee's gross income.

The bill provides that an employer may compute the gross profit percentage on the basis of all merchandise held for sale to customers (including employee customers) in the employer's line of business in which the employee works. As an alternative, the employer may select any reasonable classification of such merchandise for the computation. For example, a retail department store business may compute a gross profit percentage for the store business as a whole, or may compute different gross profit percentages for different departments or types of merchandise (high markup items versus low markup items), provided such classifications are made on a reasonable basis. Under either computation method, the determination of the gross profit percentage is to be made on the basis of the employer's experience during a representative period, such as the prior year.

Services.—The discount exclusion for a service is limited to 20 percent of the selling price of the service; there is no profit percentage limitation. The selling price is the price at which the service is provided in the ordinary course of business to customers who are not employees.[12]

Selling price.—Regulations under section 61 for the valuation of nonexcluded discounts provided to employees are to provide that if, in a line of business, a discounted price is, in effect, the price at which a product or service is offered to the public because a discount is regularly provided by the employer in the ordinary course of business through arrangements negotiated with large groups of consumers (e.g., to all members of professional associations) and substantial sales are made at a discount under these agreements, then the fair market value of the discounted products or services is to be measured by reference to the regularly discounted group selling price. In such a case, the regularly discounted group selling price also is to be used to compute the limit on the exclusion for qualified employee discounts on services, for example, so that an employee includes amounts in income on a purchase of services at a discount only to the extent that the price charged to the employee was less than 80 percent of the discounted group selling price.

Leased sections of department stores

In cases in which a department store leases floor space to another employer (such as a cosmetics firm), and employees of the lessee engage in over-the-counter sales of merchandise which appear to the public to be made by department store employees, then, for purposes of the exclusion in the bill for qualified employee discounts, the leased section is treated as part of the line of business of the employer operating the department store, and the employees of the lessee who are in the leased section are treated as employees of the department store. Thus, even if such individuals selling cosmetics on the department store floor are actually employees of the cosmetic company rather than of the store, they are considered employees of the department store for purposes of the exclusion for qualified employee discounts. Accordingly, if these individuals in the leased section receive from the store a qualified discount on their purchases of goods in the store other than cosmetics, the amount of the discount (subject to the profit percentage limitation) is excluded from income. (Of course, the exclusion is not available to other employees of the cosmetics firm who do not engage in over-the-counter sales in the leased section of the store.) Likewise, because the cosmetic section itself is considered part of the department store line of business, any qualified discount allowed to department store employees by the cosmetics firm to purchase cosmetics in the leased section is excluded (subject to the profit percentage limitation).

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[12] For purposes of this provision, an insurance policy is considered a service. Thus, an exclusion is allowed for up to 20 percent of the price of the policy.

This exclusion does not apply to loans given by financial institutions to their employees at a discounted rate of interest. Under a series of court decisions, the provision of such a loan has been held not to give rise to gross income under section 61. The exclusions under the bill do not amend or modify section 61, but rather serve to exclude from gross income benefits which constitute gross income under that section. No inference is intended as to the proper treatment of discount-interest or interest-free loans under section 61.

4. Working Condition Fringe (Sec. 502 of the bill and new Code sec. 132(d))

General rules

Under the bill, the fair market value of any property or services provided to an employee of the employer is excluded for income and employment tax purposes to the extent that the costs of the property or services would be deductible as ordinary and necessary business expenses (under Code secs. 162 or 167) if the employee had paid for such property or services. The nondiscrimination rules applicable to certain other provisions of Title V of the bill do not apply as a condition for exclusion as a working condition fringe, except for employee parking (as described below).

Examples

By way of illustration, the value of use by an employee of a company car or airplane for business purposes is excluded as a working condition fringe. (However, use of a company car or plane for personal purposes is not excludable. Merely incidental personal use of a company car, such as a small detour for a personal errand, might qualify for exclusion as a de minimis fringe.) As another example, assume the employer subscribes to business periodicals for an employee (e.g., a brokerage house buys a financial publication for its brokers). In that case, the fair market value of the subscriptions is an excluded working condition fringe, since the expense could have been deducted as a business expense if the employee had directly paid for the subscription.

Examples of other benefits excluded as working condition fringes are those provided by an employer primarily for the safety of its employees, if such safety precautions are considered ordinary and necessary business expenses. For example, if for security reasons the U.S. Government or a private business provides a bodyguard or car and driver to an employee, the value of the bodyguard or use of the car and driver is treated as a working condition fringe and hence is not includible in income of the employee. Other examples of excluded working condition fringes are employer expenditures for on-the-job training or travel by an employee if such expenditures meet the present-law requirements for deductibility under section 162.

In contrast, assume that an employer agrees to pay the real estate broker's commission on the sale of an employee's house to assist the employee in moving to another job site for the employer. The payment of the commission by the employer is not excludable as a working condition fringe, because direct payment of the commission expense by the employee would not be deductible by the employee as a section 162 business expense.[13]

The fair market value of the use of consumer goods which are manufactured for sale to nonemployee customers and which are provided to employees for product testing and evaluation outside the employer's office is excluded as a working condition fringe only if (1) consumer testing and evaluation of the product is an ordinary and necessary business expense of the employer, (2) business reasons necessitate that the testing and evaluation be performed off-premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities), (3) the item is furnished to the employee for purposes of testing and evaluation, (4) the item is made available to the employee for no longer than necessary to test and evaluate its performance, and the item must be returned to the employer at completion of the testing and evaluation period, (5) the employer imposes limitations on the employee's use of the item which significantly reduce the value of any personal benefit to the employee, and (6) the employee must submit detailed reports to the employer on the testing and evaluation. The fifth requirement above is satisfied, for example, if (i) the employer places limitations on the employee's ability to select among different models or varieties of the consumer product which is furnished for testing and evaluation purposes, (ii) the employer's policy provides for the employee, in appropriate cases, to purchase or lease at his or her own expense the same type of item as that being tested (so that personal use by the employee's family will be limited), and (iii) the employer requires that members of the employee's family generally cannot use the item. If products are furnished under a testing and evaluation program only to officers, owners, or highly compensated employees, this fact may be considered in a determination of whether the goods are furnished for testing and evaluation purposes or for compensation purposes, unless the employer can show a business reason for the classification of employees to whom the products are furnished (e.g., that automobiles are furnished for testing and evaluation by an automobile manufacturing company to its design engineers and supervisory mechanics).

Employee parking

Under a special rule in the bill, the fair market value of free or reduced-cost parking provided to an employee on or near the business premises of the employer is excludable as a working condition fringe. For officers, owners, or highly compensated employees, however, this exclusion applies only if such parking is available on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill).

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[13] A portion of this amount might be deductible, however, as a moving expense under Code section 217.

Demonstration use by auto salespersons

Under a special rule, the fair market value of any use of an employer-provided automobile by an automobile salesperson in the geographic sales area in which the dealer's sales office is located is an excludable working condition fringe if (1) such use of the car is provided primarily for the purpose of facilitating the salesperson's performance of services for the employer, and (2) there are substantial restrictions on the personal use of the car by the salesperson. For example, if an auto salesperson is required to have a car available for showing to customers during working hours, is required to drive the make of car which the auto dealer sells, is limited in the amount of miles he or she may drive the auto, may not store personal possessions in the auto, and is prohibited from using the car for vacation trips, then use of the car in the sales area qualifies for the exclusion under the bill.

5. De Minimis Fringe (Sec. 502 of the bill and new Code sec. 132(e))

General rules

Under the bill, if the fair market value of any property or a service that otherwise would be a fringe benefit includible in gross income is so small that accounting for the property or service would be unreasonable or administratively impracticable, the value is excluded for income and employment tax purposes. The nondiscrimination rules applicable to certain other provisions of the bill do not apply as a condition for exclusion of property or a service as a de minimis fringe, except for subsidized eating facilities (as described below).

In determining whether the de minimis exclusion applies, the fair market values of all property or services provided to an individual during a calendar year are to be aggregated, *except* for (1) property or services that are excluded from taxation under another specific statutory exclusion provision of the Code, as amended by this bill (such as health benefits or qualified employee discounts) and (2) any nonexcluded property or service provided to the employee that (without regard to the aggregation rule) does not qualify as a de minimis fringe because the value of the individual item is too large.

To illustrate, benefits which generally are excluded from income and employment taxes as de minimis fringes (without regard to the aggregation rule) include the typing of personal letters by a company secretary, occasional personal use of the company copying machine, monthly transit passes provided at a discount not exceeding $15, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare because of overtime work, traditional holiday gifts of property with a low fair market value, occasional theatre or sporting event tickets, and coffee and doughnuts furnished to employees.

Subsidized eating facilities

If an employer provides and operates an eating facility for its employees on or near the employer's business premises and if revenue derived from the facility normally equals or exceeds the direct operating costs of the facility, the excess of the value of the meals over the fees charged to employees is excluded under the bill if the nondiscrimination rules (see description below) are satisfied. (Free meals provided on an employer's premises to employees for the convenience of the employer are excludable from income to the extent provided by present-law section 119, which is not amended by this bill.) While the benefits provided to a particular employee who eats regularly at such a facility may not qualify as a de minimis fringe absent this rule, the recordkeeping difficulties involved in identifying which employees ate which meals on particular days, as well as the values and costs for each such meal, led the committee to conclude that a general exclusion should be provided for subsidized eating facilities as defined in the bill.

6. Qualified Tuition Reductions (Sec. 503 of the bill and Code sec. 117)

The bill adds a new provision to Code section 117 (relating to scholarship and fellowship grants) to exclude, for income and employment tax purposes, the amount of qualified tuition reductions, including cash grants for tuition, provided to an employee of an educational institution (as defined in Code sec. 170(b)(1)(A)(ii)). This new provision supersedes, as of the effective date of the provision, the existing regulation relating to tuition remission (Reg. sec. 1.117-3(a), last sentence). To qualify for the exclusion, the tuition reductions must be made available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill).

The exclusion in the bill applies only with respect to tuition for education at the elementary, secondary, or undergraduate levels. The exclusion applies whether the education is at the employer educational institution or at another educational institution. Although this exclusion does not apply with respect to tuition reductions for education at the graduate level, the committee notes that tuition reductions for graduate education may be excludable, under certain conditions, under the present-law provisions applicable to scholarships (sec. 117(b)) or to educational assistance to employees (sec. 127).

The bill provides that the exclusion is available only for tuition reductions for the education of (1) an individual who is currently employed by the educational institution; (2) an individual who separated from service with the educational institution by reason of retirement or disability; and (3) a widow or widower of an individual who died while employed by the educational institution or of an individual who had separated from service with the educational institution by reason of retirement or disability. Also, the education may be provided to the spouse or a dependent child of an individual described in the previous sentence.[14]

The qualified tuition reduction provision of the bill applies with respect to education furnished after June 30, 1984. The committee intends that present practice with respect to the tax treatment of tuition reduction provided to employees of educational institutions is to remain unchanged until this provision is effective.

7. Athletic Facilities (Sec. 502 of the bill and new Code sec. 132(h)(5))

In general, the fair market value of any on-premises athletic facility provided and operated by an employer for its employees, where substantially all the use of the facility is by employees of the employer (or their spouses or dependent children[15]), is excluded under the bill for income and employment tax purposes. The athletic facility need not be in the same location as the business premises of the employer, but must be located on premises of the employer and may not be a facility for residential use. Examples of athletic facilities are swimming pools, gyms, tennis courts, and golf courses.

The exclusion for certain employer-provided athletic facilities does not apply to the providing of memberships in a country club or similar facility unless the facility itself is owned and operated by the employer and satisfies the employee-use and other requirements for the exclusion. Thus, where no exclusion is available under this provision, the fair market value of such country club membership is includible in the income of the employee who is provided with membership, and is deductible to the extent permitted by present-law sections 162 and 274.

A nondiscrimination requirement is not provided in the bill as a condition for this exclusion, because present law (Code sec. 274) denies a deduction to the employer for costs attributable to a facility which is primarily for the benefit of officers, owners, or highly compensated employees.

8. Nondiscrimination Rules

To qualify under the bill for the exclusions for no-additional-cost services, qualified employee discounts, employee parking or eating facilities, or qualified tuition reductions, the benefit must be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees (the "highly compensated group"). If the availability of the fringe benefit does not satisfy this nondiscrimination test, the exclusion applies only to those employees (if any) who receive the benefit and who are not members of the highly compensated group. For example, if an employer offers a 20-percent discount (which otherwise satisfies the requirements for a qualified employee discount) to rank-and-file employees and a 35-percent discount to the highly compensated group, the entire value of the 35-percent discount (not just the excess over 20 percent) is includible in gross income and wages of the members of the highly compensated group who make purchases at a discount.

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[14] For this purpose, dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee who is a dependent of the employee or both of whose parents have died. A child of divorced, etc., parents to whom section 152(e) applies is treated as a dependent of both parents.

[15] See note 6, *supra*.

The determination of whether a particular classification is reasonable depends on the facts and circumstances involved. A classification that, on its face, makes benefits available only to officers, owners, or highly compensated employees is per se discriminatory, and no exclusion is available to the highly compensated group members for the value of such benefits. On the other hand, an employer could establish a classification that is based on certain appropriate factors, such as seniority, full-time vs. part-time employment, or job description, provided that the effect of the classification is nondiscriminatory. For example, availability of a tuition reduction benefit only to those college employees who are faculty members is not per se discriminatory. A determination that a classification is reasonable for purposes of applying the nondiscrimination rules of this bill is not to be taken as an indication as to whether or not the classification is reasonable for purposes of applying other nondiscrimination rules in the Code, such as the rules in section 401(a)(4) for qualified pension plans.

Thus, for example, if an employer makes free or reduced-cost parking available to all its employees according to seniority or on a "first-come, first-served" basis, and if those employees who obtain parking constitute a fair cross-section of all employees, then the fair market value of the parking provided is excluded under the bill. A preferential assignment to highly compensated group members of parking space when made for legitimate business reasons (such as a need to use their cars for sales trips or plant inspections during the work day) does not itself violate the nondiscrimination rule, provided that any remaining parking spaces are available to employees on a nondiscriminatory basis. Further, in a situation where parking space is made available on a nondiscriminatory basis, the assignment of particular locations within the parking facility does not have to be made on a nondiscriminatory basis. On the other hand, if an employer provides free or reduced-cost parking only to highly compensated employees without legitimate business reasons, the fair market value of the parking is not excluded for those highly compensated employees.

Another example of a fringe benefit to which the nondiscrimination requirement applies is the provision by colleges of tuition reduction to employees and their families. Suppose that a college makes this benefit available only to faculty and administrators, including non-tenured faculty, but not to employees in other categories, such as clerical and maintenance. To determine whether such a classification would be discriminatory in this particular case, all employees of the college would be divided into categories according to their level of compensation. If the number of the most highly compensated employees to whom the tuition reduction benefit is available, as a proportion of all employees in that category, were not substantially higher than the corresponding proportions for the remaining categories of employees, then the classification would not be considered to be one that discriminated in favor of the highly compensated.

For purposes of the nondiscrimination rule, the determination of which employers are highly compensated would depend on the facts and circumstances of the case, but could rely on Treasury Department guidelines. Examples of such guidelines could be that employees with compensation above, for example, a specific percentile in the employer's compensation distribution or above, for example, a specific annual rate, or both, are to be treated as highly compensated. Such guidelines could vary by industry and could reflect unique characteristics of particular employers or particular industry categories of employment. The committee intends that, insofar as practicable, the Internal Revenue Service is to issue advance determinations as to whether the nondiscrimination requirements of the bill are met in the case of employers, such as nonprofit organizations, to which similar requirements in other sections of the Code have not frequently been applied.

The nondiscrimination rules do not apply to a working condition fringe (other than parking) or a de minimis fringe (other than subsidized eating facilities). For example, if an employer for valid business reasons makes a bodyguard available only to its executives, the working condition fringe exclusion applies even though the availability of the benefit would not satisfy the nondiscrimination rules of the bill.

9. Other Rules

Definition of employer

For purposes of new Code section 132, all employees of all corporations that are members of a controlled group of corporations (within the meaning of Code sec. 414(b)), all employees of all trades or businesses (whether or not incorporated) under common control (sec. 414(c)), or all employees of an affiliated service group (sec. 414(m)) are treated as employed by a single employer. Consequently, if a chain of retail hardware stores separately incorporates each hardware store as a wholly owned subsidiary of one corporation, the employees of one subsidiary may receive qualified employee discounts from stores operated by the other subsidiaries (since all such hardware stores are in the same line of business). Similarly, the nondiscrimination rules are applied under the bill by aggregating related employers, but without aggregating employees in different lines of business (as defined above in the descriptions of the exclusions for no-additional-cost services and qualified employee discounts).

Under the bill, the aggregation of commonly controlled, etc., employers does not change the other requirements for exclusion. For example, if a controlled group of corporations consists of two corporations whose products are in different industry groups, they are not considered as consisting of a single line of business even though treated as one employer. Thus, for example, a qualified employee discount received from a related employer is excludable only if that employer is engaged in the same line of business as that in which the employee works.

Nonapplicability to certain fringe benefits

A benefit is not excludable under new Code section 132 (except pursuant to the exclusion for de minimis benefits) if another section of the Internal Revenue Code provides rules for the tax treatment of that general type of benefit. For example, the fair market value of day care services provided to an employee is excludable only pursuant to the provisions of Code section 129. If in a particular situation such services do not qualify for exclusion under section 129 (e.g., because the nondiscrimination requirements of that section are not met), no exclusion is available under the bill (other than the de minimis exclusion).

Correspondingly, the provisions of section 132 do not modify any present-law statutory exclusions (except to the extent that the bill modifies the definition of cafeteria plans under sec. 125). For example, Code section 119 excludes from the gross income of an employee the value of meals furnished on the employer's business premises for the convenience of the employer. Under Treasury regulations, meals provided free of charge are treated as furnished for the employer's convenience if the meals are furnished for a substantial noncompensatory business reason of the employer. For example, on-premises meals satisfy this requirement if furnished so that the employee is available for emergency calls during meal periods, if employees are restricted to a short meal period which precludes eating out, or if there are insufficient eating facilities in the vicinity (Treas. Reg. sec. 1.119-1(a)). The bill does not affect the present-law exclusion provisions of section 119.

10. Cafeteria Plans (Sec. 502(b) of the bill and Code sec. 125)

The bill amends the definition of cafeteria plans for purposes of Code section 125 to provide that such plans may offer employees choices only among cash or those fringe benefits (other than scholarships or fellowships, educational assistance, vanpooling, and those benefits excludable under provisions of the bill) that are excludable from gross income under a specific section of the Internal Revenue Code.

For this purpose, group-term life insurance that is includible in income only because the amount of the insurance exceeds $50,000 is treated as a nontaxable benefit. With respect to vacation days offered under a cafeteria plan, vacation days which cannot be cashed out in a later year also are to be treated as a nontaxable benefit. However, vacation days which may be cashed out in a later year are to be treated as deferred compensation which may not be offered under a cafeteria plan.

11. Treasury Regulations (Sec. 502 of the bill and new Code sec. 132(k))

Treasury regulations are to be issued to implement the provisions of this bill. Such regulations must be consistent with the language of the bill and with the legislative history (as reflected, in part, in the committee reports on the bill). Thus, any example of a fringe benefit which the reports state is excluded under the bill from income and wages must be so treated in the regulations.

Any fringe benefit that does not qualify for exclusion under the bill (for example, free or discounted goods or services that are made available by the employer only to corporate officers) or under another specific statutory fringe benefit provision is includible in gross income (under Code sections 61 and 83) for income tax purposes, and subject to income tax withholding, FICA, and FUTA, at the excess of its fair market value over any amount paid by the employee for the benefit. For purposes of assisting both taxpayers and the IRS, the Treasury is to issue regulations setting forth appropriate and helpful rules for the valuation of taxable fringe benefits and coordinating the applications of sections 61 and 83.

The committee notes that noncash remuneration generally is already subject to FICA, FUTA, and income tax withholding under present law. It is intended that, in the absence of a specific statutory provision to the contrary, the regulations under these provisions are to be revised to make clear that remuneration for employment should not be exempt from these employment taxes merely because the remuneration is paid in the form of property or services rather than cash. Since the statutory term "remuneration" is to be interpreted broadly to include compensation for services which have been performed, noncash benefits (such as allowances for meals when the employee is not away from home overnight) which are not excluded under the provisions of this bill or other statutory provisions are to be subject to these employment taxes. This broad interpretation of remuneration is especially important in the case of FICA, for which withholding is generally the only collection method available. In providing guidance to employers concerning the time at which noncash remuneration is considered to be paid by the employer and thus subject to employment taxes, the regulations are to allow sufficient flexibility to minimize administrative problems which employers may have in complying with the law.

The committee understands that under established practices in certain industries, employers may make available to employees damaged, distressed, or returned goods at a price which equals or exceeds the fair market value of such items but which may be less than the cost to the employer of the items before being damaged, etc. In such situations, no amount is to be includible in the employee's income where the purchase price paid by the employee equals or exceeds the fair market value of the item.

Under existing Code provisions and section 61 regulations, benefits to military personnel such as subsistence, housing, and uniform allowances are excludable from income (see Treas. Reg. sec. 1.61-2(b)). This bill does not make any change in existing excludable military benefits. Thus, for example, the value of discounts at military commissaries is to be considered as provision of subsistence under existing regulations and fully excludable without regard to the bill.

D. Effective Date

The provisions of the bill generally take effect on January 1, 1984, except that the exclusion for qualified tuition reductions (sec.

503 of the bill) applies with respect to education furnished after June 30, 1984.

E. Revenue Effect

It is estimated that the provisions of title V of the bill will have no significant revenue effect. The bill serves to codify many present practices under which employers provide their own products and services tax-free to a broad group of employees.

TITLE VI — THE TECHNICAL CORRECTIONS ACT OF 1983

The Technical Corrections Act of 1983 contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983 and other recently enacted tax legislation. All amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is set forth for each individual amendment.

A. Technical Corrections to the Tax Provisions of the Tax Equity and Fiscal Responsibility Act of 1982

1. Alternative minimum tax (sec. 611(a) of the bill and secs. 55-58 of the Code)

Present Law

TEFRA[1] added several new tax preferences and made certain other modifications to the individual alternative minimum tax. This tax is computed at a 20-percent rate and is payable to the extent it exceeds the taxpayer's regular tax. Regular tax generally means the taxpayer's income tax liability reduced by nonrefundable credits. TEFRA generally allowed individuals to elect to take ACRS deductions and the investment tax credit with respect to intangible drilling costs. Also TEFRA provided that the circulation expense deduction, to the extent it exceeded a deduction based on 10-year amortization, was a tax preference for individuals.

Explanation of Provision

In order that a taxpayer may not avoid recapture of investment tax credit on disposition of investment credit property by reason of being subject to the alternative minimum tax, the bill clarifies that the amount of investment credit recapture is not included in the taxpayer's regular tax for purposes of computing alternative minimum liability. As a result, the recapture tax will be a liability in addition to the taxpayer's alternative minimum tax and regular tax.

Also, the bill provides that the election to take ACRS deductions and the investment credit in lieu of expensing intangible drilling costs would not be available with respect to oil, gas and geothermal wells which are not located in the United States, since the investment credit is generally not allowable for property used outside the United States.

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[1] The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

Further, the bill amends the circulation expense tax preference provisions by providing a 3-year amortization period (rather than the 10-year period) for individuals to amortize circulation expenses and to measure the tax preference where the expenses are deducted in full under section 173.

2. Casualty loss deduction (sec. 611(c) of the bill and sec. 165 of the Code)

Present Law

TEFRA provided that the itemized deduction for nonbusiness casualty and theft losses is allowed only to the extent the losses exceed 10 percent of the taxpayer's adjusted gross income. In determining adjusted gross income, the deduction for capital gain (under sec. 1202) is allowed. Where a taxpayer's recognized gains from certain involuntary conversions or other casualty losses are in excess of the recognized losses for those transactions for a taxable year, the taxpayer's capital gains deduction for that year, and therefore his or her adjusted gross income, may depend on the amount of casualty loss which is allowable as a deduction (sec. 1231). Thus, in certain circumstances, the computation of the casualty loss deduction may not be mathematically determinable because of the interrelationship with the adjusted gross income determination.

Explanation of Provision

In order to break this circular computation, the bill provides that adjusted gross income, for purposes of computing the 10-percent floor for the casualty loss deduction, is determined without regard to the application of section 1231 to gain or loss from involuntary conversions arising from casualty or theft.

The bill also clarifies that the adjusted gross income limitation applies to estates and trusts.

3. Corporate minimum tax (sec. 612(a) of the bill and sec. 291 of the Code)

Present Law

TEFRA provided a 15-percent cutback in certain corporate tax preferences. These preferences include section 1250 recapture on real estate, mining exploration and development costs, interest incurred by financial institutions to carry certain tax-exempt obligations, and intangible drilling costs of integrated oil companies.

Explanation of Provision

The bill provides that the additional gain recognized as ordinary income on the disposition of section 1250 property under the cutback provision is treated, for all purposes of the Code (such as sections 170, 341, 453B and 751), in the same manner as other section 1250 gain. Since the investment tax credit is generally not allowed for property used outside the United States, the bill provides that no investment credit is allowed for mineral exploration and development costs with respect to mineral deposits located outside the United States. The bill clarifies that, for purposes of applying the preference cutback with respect to interest of financial institutions used to carry tax-exempt bonds, amounts paid in respect of deposits, investment certificates, or withdrawable or repurchased shares are treated as interest, whether or not designated as interest. Finally, the bill clarifies the language providing for the 36-month amortization of drilling and mining costs which are otherwise disallowed by the section.

4. Investment tax credit basis adjustment (sec. 612(b) of the bill and sec. 48(q) of the Code)

Present Law

TEFRA provided a basis adjustment for property with respect to which the investment tax credit is allowed.

Explanation of Provision

The bill clarifies that the basis in a partnership or S corporation is adjusted to reflect adjustments to the basis of partnership or S corporation property where investment credits are either allowed or recaptured. The subsequent reduction of ACRS deductions by reason of the adjustment to the basis of the assets required by TEFRA results in a subsequent lesser reduction in the basis of the partnership interest or S corporation stock.

5. Construction period interest and taxes (sec. 612(c) of the bill and sec. 189 of the Code)

Present Law

TEFRA provided that corporations must capitalize construction period interest and taxes with respect to nonresidential real property.

Explanation of Provision

The bill clarifies that construction period interest and taxes with respect to dwelling units in a cooperative housing corporation (as defined in sec. 216) is exempt from the capitalization requirement, since that property is residential property.

6. Leasing (sec. 612(d) and (g) the bill, sec. 168 of the Code, and secs. 210 and 217(e) of TEFRA)

a. Mass commuting vehicles

Present Law

In general, TEFRA modified the safe-harbor leasing rules for leases entered into or property placed in service after July 1, 1982, and repealed safe-harbor leasing for leases entered into after December 31, 1983. However, the TEFRA modifications and repeal of the safe-harbor leasing rules do not apply to qualified mass commuting vehicles. A qualified mass commuting vehicle must be financed in whole or in part by obligations the interest on which is excludable from income.

TEFRA also included a provision to specifically designate ferries as mass commuting vehicles. The effective date of this provision was generally for obligations issued after the date of enactment of TEFRA.

Explanation of Provision

The bill clarifies that, for purposes of safe-harbor leasing, the provision designating ferries as mass commuting vehicles applies to agreements entered into after the date of enactment of TEFRA, without regard to the date on which obligations were issued.

b. Motor vehicle leases

Present Law

Prior to the enactment of TEFRA, the Internal Revenue Service took the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes.[2] However, TEFRA provided that the presence of a terminal rental adjustment clause is not to be taken into account in determining whether an agreement is a lease. The TEFRA provision was intended to prevent the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases. The TEFRA provision does not address the legal effect of a terminal rental adjustment clause, nor does it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis.[3] The TEFRA provision applies only to operating leases in which the lessee uses the property for business purposes, and if the lessor acquires the property with cash or recourse indebtedness. The TEFRA provision defines a terminal rental adjustment clause as a provision of an agreement that permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the property.

Explanation of Provision

The bill makes two clarifying amendments to the TEFRA provision for terminal rental adjustment clauses.

The bill clarifies that the term "terminal rental adjustment clause" also includes a provision of an agreement that requires a lessee who is a dealer in motor vehicles to purchase the property for a predetermined price and then resell the property, where such a provision achieves substantially the same results as a provision that permits an upward or downward adjustment of rentals after the disposition of the property by a lessor.

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[2] Technical Advice Memorandum 8019120 (December 20, 1979)

[3] After the enactment of TEFRA, the Internal Revenue Service issued proposed regulations on a prospective basis, under which the presence of a terminal rental adjustment clause would indicate that a motor vehicle agreement is not a lease.Before the enactment of TEFRA, the Tax Court addressed the legal effect of terminal rental adjustment clauses in motor vehicle leases, holding that these transactions are leases and not conditional sales. However, after the enactment of TEFRA, the Ninth Circuit Court of Appeals reversed the Tax Court and upheld the position of the Internal Revenue Service. *Swift Dodge* v. *Comm'r*, 696 F.2d 651 (9th Cir. 1982), *rev'g*, 76 T.C. 547 (1981).

The bill also provides that the TEFRA provision shall not apply to a motor vehicle agreement if the lessee treated itself as the owner of the motor vehicle on a Federal income tax return that was filed before the date of the enactment of TEFRA. This provision is intended to protect lessees who had complied with the position of the Internal Revenue Service and treated agreements containing terminal rental adjustment clauses as conditional sales, but who could face retroactive increases in tax liability as the result of the enactment of the TEFRA provision for terminal rental adjustment clauses.

7. Foreign taxation (sec. 612 (e) and (f) of the bill and sec. 907 of the Code)

a. Recapture of foreign oil losses

Present Law

TEFRA eliminated the separate foreign tax credit limitation for foreign oil income. Absent relief, the Code's foreign loss recapture rule would cause immediate recapture of one kind of loss (oil or non-oil) against the other kind of income. A special rule, however, limits recapture to 12.5 percent of the pre-TEFRA loss per year. In some cases, however, taxpayers may prefer recapture more rapid than the ratable 12.5 percent per year recapture of present law. For instance, a taxpayer who anticipates receipt of low-taxed foreign source income in the near future and receipt of high-taxed foreign source income in later years may prefer more rapid recapture. In providing relief for taxpayers who benefit from ratable 12.5 percent recapture, Congress did not intend to penalize other taxpayers.

Explanation of Provision

The bill makes clear that taxpayers can elect recapture of one kind of loss (oil or non-oil) over a period shorter than eight years.

b. Definition of foreign oil related income

Present Law

TEFRA imposed current U.S. tax on the U.S. shareholders of controlled foreign corporations that earn foreign base company oil related income. Foreign base company oil related income for this purpose means certain foreign oil related income as defined in section 907(c)(2).

Explanation of Provision

The bill supplements the definition of foreign base company oil related income by specifying that the term also includes foreign oil related income as defined in section 907(c)(3). The term will include certain dividends, interest, deemed distributions under the Subpart F rules, and partnership income. The term will include these amounts only to the extent they constitute foreign oil related income; the term will not include amounts that constitute foreign oil and gas extraction income.

8. Partial liquidations (sec. 612(h) of the bill and sec. 543 of the Code)

Present Law

TEFRA provided that distributions to corporate shareholders in a partial liquidation are excluded from the definition of personal holding company income notwithstanding that they otherwise constitute dividends under the revised treatment of partial liquidations.

Explanation of Provision

In order to treat all dividends in the same manner, the bill deletes this exclusion so that dividends otherwise constituting personal holding company income will be so treated notwithstanding that they are made in a partial liquidation of the distributing corporation.

9. Distribution of appreciated property in redemption of stock (sec. 612(i) of the bill and sec. 311 of the Code)

Present Law

Generally, distributions of appreciated property in redemption of a corporation's stock result in recognition of gain to the distributing corporation. TEFRA excepts from the recognition requirement distributions in partial liquidations and certain distributions of stock or obligations of a controlled corporation if made with respect to qualified stock. Qualified stock is stock held by a noncorporate shareholder who has held at least a 10-percent interest in the distributing corporation for 5 years prior to the distribution (or such lesser period as the distributing corporation or its predecessor existed). The treatment of distributions made to pass-through entities is not entirely clear under the language of TEFRA.

Explanation of Provision

The bill amends the rules relating to qualified stock to provide that, in determining whether the definition of qualified stock is satisfied, distributions to pass-through entities (S corporations, partnerships, trusts, and estates) will be treated as if made directly to the shareholders, partners, or beneficiaries in proportion to their respective interests in the entity. Thus, for example, a distribution to a partnership will not qualify as a distribution with respect to qualified stock to the extent that interests in the partnership are owned by corporations. Further, distributions will not qualify to the extent of an interest in the partnership held by any person whose interest is less than 10 percent, unless stock attributable to such interest when combined with other stock held actually or constructively by such person satisfies the 10-percent requirement. Further, regardless of how long the partnership held the stock in the distributing corporation, the distribution will not satisfy the holding period requirement to the extent it is attributable to a partner whose interest in the partnership was acquired within 5 years (or within such shorter period as the distributing corporation or its predecessor existed) prior to the distribution. Where, however, the stock was contributed to the partnership by the partner, the combined period of ownership by the partner and the partnership will constitute the holding period applicable to the partner.

10. Treatment of certain stock purchases (sec. 612(j) of the bill and sec. 338 of the Code)

a. Definition of purchase for treating certain stock purchases as asset acquisitions

Present Law

A corporation making a qualified stock purchase may treat the acquisition as if the assets of the acquired corporation were purchased. Prior to TEFRA, this treatment applied only if the acquired corporation was liquidated. Under the TEFRA revision of prior law, if the purchasing corporation elects such treatment, the acquired corporation is treated as a new corporation which purchased the assets as of the beginning of the day after the date the qualified stock purchase was completed. Generally, the election may be made only if 80 percent or more of the stock (other than certain nonvoting preferred stock) of the acquired corporation is purchased within a 12-month period.

Stock owned by the acquired corporation in a third corporation is treated as purchased by the acquiring corporation if, as a result of the purchase of stock of the acquired corporation, the acquiring corporation is treated as constructively owning stock in such third corporation. When a corporation (the first corporation) purchases 80 percent of the qualifying stock of another corporation (the second corporation) which in turn owns 80 percent of the stock of a third corporation, the first corporation has not made a qualified stock purchase of the third corporation because it is treated as having purchased only 64 percent (80 percent of 80 percent) of the qualifying stock of such third corporation. However, if an election is made with respect to the qualified stock purchase of the second corporation, the second corporation will be treated as a new corporation which has purchased 80 percent of the third corporation's stock. It is not clear whether such deemed purchase is a qualified stock purchase which enables the second corporation to make an election with respect to the third corporation.

Explanation of Provision

The bill generally conforms the definition of purchase to the definition of prior law (section 334(b)(2)). Under the bill, a purchasing corporation will not be treated as having purchased stock in a third corporation which it constructively owns as a result of purchasing the stock in another (the second) corporation. Instead, if a qualified stock purchase and election are made with respect to the second corporation, the deemed purchase of the third corporation's stock will (if it satisfies the 80-percent ownership requirement) be treated as a qualified stock purchase permitting an election by the second corporation, or deeming an election to be made under certain consistency of treatment requirements, with respect to the third corporation. The acquisition date applicable to the deemed sale by the second corporation is also the acquisition date applicable to the deemed sale by the third corporation.

Generally, under the bill, an election may be made only by a corporation which has made a direct acquisition by purchase of stock satisfying the 80-percent ownership requirement. For this purpose, stock acquired (including stock acquired in a carryover basis transaction after a qualified stock purchase and election with respect to the transferor) from a related corporation, in a transaction which otherwise satisfies the "purchase" requirement, will be treated as purchased if at least 50 percent in value of the stock of the related corporation was acquired by purchase. A corporation is related if stock owned by it is owned by the acquiring corporation. The 12-month acquisition period within which a qualified stock purchase must be made commences, under the bill, not later than the date on which an acquiring corporation first constructively owns stock (other than through ownership of an option) acquired from a related corporation.

b. Limitation on nonrecognition of gain or loss in certain stock purchases treated as asset acquisitions

Present Law

When an election results in treating an acquired corporation as having sold its assets, gain or loss is not recognized on such constructive sale to the same extent as gain or loss would not be recognized under the rules applicable to an actual sale of assets by, and liquidation of, the acquired corporation (under sec. 337). However, where less than all the stock of such corporation is owned by the acquiring corporation, the portion of the gain or loss not recognized is limited to the highest percentage by value of the acquired corporation's stock owned by the acquiring corporation during the 1-year period commencing with the date the qualified stock purchase is completed (the acquisition date). Nonrecognition treatment is not so limited if the acquired corporation is liquidated during such 1-year period. Nonrecognition is limited in lieu of imposing a shareholder tax on minority shareholders not disposing of their stock.

Explanation of Provision

Under the bill, the highest percentage of stock held by the acquiring corporation, for purposes of limiting nonrecognition of gain or loss, will be determined by counting increases in its stock ownership after the acquisition date only to the extent such increases are attributable to purchases, or to redemptions by the target corporation to which either (i) section 302(a) applies, or (ii) in the case of a shareholder who is not a corporation, to which sec. 301 applies. Further, under the bill, the exception to nonrecognition treatment for liquidations during the one-year period is not available if the liquidation is one to which sec. 333 applies. These restrictions are intended to limit nonrecognition of gain or loss to the acquired corporation resulting from transactions after the acquisition date to cases in which stock held by minority shareholders was disposed of in taxable transactions.

c. *Purchases by more than one member of an affiliated group in connection with certain stock purchases treated as asset acquisitions*

Present Law

If there is both a direct purchase of assets and a qualified stock purchase from the same affiliated group, except as otherwise provided there is a deemed election to treat the stock purchase as a sale and purchase of assets by the acquired corporation. Similarly, if two or more qualified stock purchases are made from the same affiliated group, an election of, or failure to elect, asset sale treatment must be consistently applied to all the acquisitions. In applying these rules, an acquisition of assets or stock by a member of the same affiliated group as the purchasing corporation is treated as made by the purchasing corporation.

Explanation of Provision

The bill clarifies that the aggregation of acquisitions of assets or stock by members of the purchasing corporation's affiliated group is intended to apply only for purposes of the provisions requiring consistency of treatment where assets and stock are purchased, or multiple stock purchases are made, from the same affiliated group. In applying the consistency rules, it is not necessary that the 80-percent purchase requirement be satisfied by one member. However, outside the consistency rules, no qualified stock purchase takes place where several members of an affiliated group that does not file a consolidated return, in the aggregate purchase the required 80 percent of an acquired corporation's outstanding stock but no one member separately satisfies the 80-percent purchase requirement.

d. *Nonrecognition treatment on the sale or exchange of property in connection with certain stock purchases treated as asset acquisitions*

Present Law

Gain or loss is not recognized by a corporation on the sale or exchange of property after the adoption of a plan of complete liquidation pursuant to which its assets are all distributed within 12 months (sec. 337). Under TEFRA, these nonrecognition rules apply to the constructive sale and purchase of an acquired corporation's assets resulting from a qualified stock purchase and election. It is not clear, under present law, whether nonrecognition treatment applies to the asset sales when there is a qualified stock purchase and election with respect to an acquired corporation which has sold some of its property following adoption of a plan of liquidation.

Explanation of Provision

Under the bill, if within 12 months preceding the acquisition date of a qualified stock purchase with respect to which an election is made, the acquired corporation adopted a plan of complete liquidation which was not rescinded as of such date, the nonrecognition rules of section 337 will apply to actual sales by the acquired corporation as though it had actually distributed all its assets in liquidation on the acquisition date. The same percentage of gain or loss would be recognized to the acquired corporation with respect to these sales as would be recognized on the deemed sale of its remaining assets resulting from the election. The sale of stock and the deemed distribution will have the same effect as an actual sale of its assets by the acquired corporation to the acquiring corporation followed by a distribution in complete liquidation in applying the provisions providing exclusion from collapsible corporation treatment with respect to sales and exchanges and distributions by the acquired corporation (secs. 341(e)(1), (e)(2) and (e)(4)) and the use of the installment method by shareholders of the acquired corporation (sec. 453(h)).

e. Application of collapsible corporation treatment after stock purchase treated as asset purchase

Present Law

Shareholders in a corporation formed or availed of to enable its shareholders to obtain capital gain treatment attributable to property produced by certain corporate activities before a substantial portion of the taxable income from such property is realized by the corporation, by selling or otherwise disposing of their stock, may instead receive ordinary income from such dispositions under the collapsible corporation rules (sec. 341). When a qualified stock purchase of a collapsible corporation takes place, an election may be made to treat the acquisition as a purchase of assets. However, stock may continue to be owned by minority shareholders after the acquisition date of a qualified stock purchase. Collapsible corporation treatment does not apply to a stock disposition if the corporation has realized the taxable gain from the property. However, the asset purchase election may eliminate such gain, including that attributable to minority owned shares that are purchased by the acquiring corporation, or acquired in certain redemptions, within the 1-year period following the acquisition date.

Explanation of Provision

The bill provides that the election to treat a qualified stock purchase of a collapsible corporation as an asset purchase will be disregarded for purposes of determining whether the collapsible corporation rules apply to a disposition of stock by a minority shareholder within the 1-year period following the acquisition date.

f. Fair market value as deemed sale price in certain stock purchases treated as asset acquisitions

Present Law

Under TEFRA, the price at which an acquired corporation's assets are treated as sold and purchased when an election is made with respect to a qualified stock purchase is the basis of the purchasing corporation's stock in the acquired corporation on the acquisition date, properly adjusted for liabilities and other items. For this purpose, the purchasing corporation's basis, if it owns less than 100 percent of the acquired corporation's stock, is "grossed up" to reflect 100-percent ownership. The price paid for the stock of the acquired corporation may be less than the fair market value of its assets to take account, for example, of tax liability resulting from the application of recapture provisions to the deemed purchase and sale of assets. Further, a qualified stock purchase and election may be made notwithstanding that a substantial portion of the value of an acquired corporation is attributable to a class of preferred stock not acquired as part of the qualified stock purchase. The recapture provisions and certain other taxable consequences were applied with reference to the fair market value of an acquired corporation's assets under the provisions applicable prior to TEFRA when a purchase and liquidation of a subsidiary corporation was treated as a purchase of its assets. It is not clear in all cases that a comparable result can be obtained under the adjusted stock basis formula prescribed under TEFRA for determining the deemed purchase price of the acquired corporation's assets.

Explanation of Provision

Under the bill, in order to provide recapture and other taxable treatment comparable to that applicable when a purchased subsidiary was liquidated under prior law, the deemed sale price of the acquired corporation's assets will be their fair market value as of the acquisition date. The basis of the assets is their fair market value adjusted to eliminate unrealized appreciation in the stock of the acquired corporation held by the acquiring corporation on the acquisition date. It is intended that the adjustment will properly correlate the basis of assets with the cost incurred to acquire the target corporation's stock. If, for example, the acquiring corporation owns all of the target corporation's stock outstanding on the acquisition date, the fair market value of the assets will be adjusted so that their basis, net of liabilities reflected in such basis, will equal the basis in the target corporation's stock on the acquisition date. However, if on such date, the acquiring corporation owns less than all of the target corporation's outstanding stock, the adjustment will result in a net asset basis equal to the basis of the acquiring corporation in the target corporation's stock owned by it on such date plus a percentage of unadjusted net asset fair market value equal to the percentage of the value of the target corporation's stock not owned by the acquiring corporation on such date. The fair market value as adjusted is allocated among the assets under regulations. It is intended that, to the extent of the amount taken into account in determining tax attributable to recapture income from the deemed sale of the target corporation's assets, basis will be assigned to such assets before the remaining basis, if any, is allocated among other assets.

The fair market value and the adjusted fair market value of the assets are to be properly adjusted under regulations, in determining the price at which the assets are deemed sold and purchased, for contingent payments and other relevant items. The consideration to be paid by the acquiring corporation may depend, for example, on the amount of the acquired corporation's liabilities which are not fixed on the acquisition date or on the post-acquisition date earnings of the acquired corporation. In some cases, the aggregate bases in the stock of the acquired corporation held by the acquiring corporation on the acquisition date may exceed the fair market value of the assets on such date. Proper adjustment to the basis of assets may be made to reflect such excess.

g. Period for making election in connection with certain stock purchases treated as asset acquisitions; Estimated tax penalty inapplicable

Present Law

An election following a qualified stock purchase must be made, except as regulations provide otherwise, within 75 days after the acquisition date. Section 6655 imposes an addition to the tax for failure of a corporation to timely pay its estimated tax liability.

Explanation of Provision

Under the bill, the election may be made not later than the fifteenth day of the ninth month following the month in which the acquisition date occurs, except as regulations provide otherwise. Tax attributable to the deemed sale resulting from the election will not be taken into account for purposes of the addition to tax under section 6655. Further, it is intended, if the target corporation fails to file the return or pay the tax resulting from the election by the date prescribed for such a filing or payment, that generally the failure will be deemed to be due to reasonable cause and not due to willful neglect in determining the applicability of any addition to tax as a result of such failure, providing a return is filed and the tax is paid by the date for making the election.

h. Treatment of certain liquidations for tax avoidance purposes

Present Law

Generally on a complete liquidation of a controlled subsidiary, the acquiring corporation succeeds to its tax attributes, including carryover items. Prior to TEFRA, when an acquired subsidiary corporation was liquidated pursuant to a plan of liquidation adopted within two years following a qualifying purchase of the subsidiary's stock, the transaction was treated as a purchase of the subsidiary's assets and its net operating loss and other carryforward items and other tax attributes were terminated.

Under the TEFRA revision of prior law, the treatment of a qualified stock purchase as an asset acquisition applies on the acquisition date without liquidating the acquired corporation if an election to so treat the purchase is made by the purchasing corporation. If no election is made, the acquired corporation may be immediately liquidated following its acquisition and the acquiring corporation will succeed to its tax attributes. When control of a corporation is acquired, or a corporation acquires from another corporation not controlled by the acquiring corporation or its shareholders property with a carryover basis, carryovers and other tax benefits may be disallowed if the principal purpose of the acquisition is tax avoidance or evasion. The application of this disallowance provision in not clear when a purchased corporation with unexpired carryforward items is liquidated into the acquiring corporation.

Explanation of Provision

The bill provides an explicit rule to authorize the disallowance of carryover and other tax benefits of a subsidiary corporation, acquired in a qualified stock purchase with respect to which an election of asset acquisition treatment is not made, if the subsidiary corporation is liquidated pursuant to a plan adopted within two years of the acquisition date and the principal purpose of the liquidation is tax avoidance or evasion. Further, as in Treasury regulation section 1.269-3(b)(1), it is expected regulations will provide that, in the absence of evidence to the contrary, this situation is ordinarily indicative that the principal purpose of the liquidation is tax avoidance.

i. Regulatory authority to coordinate the rules relating to foreign corporations and their shareholders with the rules applicable to an asset acquisition election

Present Law

Present law contains rules providing special treatment of United States shareholders in foreign corporations. Shareholder treatment applicable when an asset acquisition election is made with respect to a qualified stock purchase of a foreign corporation is not consistent with such rules in all cases.

Explanation of Provision

The bill provides for the issuance of such regulations as may be appropriate or necessary to provide for coordination of the rules applicable to an asset acquisition election with respect to a qualified stock purchase of a foreign corporation with the rules relating to foreign corporations and their shareholders.

11. Treatment of certain holding companies (sec. 612(k) of the bill and secs. 304 and 306 of the Code)

a. Amount constituting a dividend in certain redemptions through related corporations

Present Law

If one or more shareholders with 50 percent or greater stock ownership in one corporation transfer stock of that corporation to another corporation in which they have 50 percent or greater stock ownership in exchange for property, the transaction is treated as a dividend to the shareholders if it would be so treated by applying the redemption provisions (sec. 302) with reference to the ownership of the corporation whose stock is surrendered in the transaction. Under the TEFRA revision of these provisions, the determination of the amount which is a dividend is made as if the property were distributed from the issuing corporation to the acquiring corporation and then from the acquiring corporation to the shareholder.

This rule was intended to provide dividend treatment for property received by shareholders to the extent of the aggregate earnings and profits of both the acquiring corporation and the corporation whose stock is acquired in the transaction. However, its application is unclear because, for example, the amount treated as distributed to corporate shareholders is limited with reference to the distributing corporation's basis in the distributed property but is not so limited for shareholders who are not corporations.

Explanation of Provision

In order to clarify the application of the rule adopted by TEFRA, the bill provides that the amount which is a dividend shall be determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the corporation whose stock is acquired (the issuing corporation). The transaction would have no effect on the issuing corporation if earnings and profits of the acquiring corporation equal or exceed the amount treated as a distribution in the hands of the shareholders. If the distribution is in excess of the acquiring corporation's earnings and profits, the amount treated as distributed by the issuing corporation will not exceed the earnings and profits of such corporation.

b. Coordination of redemptions through related corporations with provisions for nonrecognition of gain or loss

Present Law

Under present law, the exchange of stock in a 50-percent controlled corporation for property from another 50-percent controlled corporation is treated as a stock redemption subject to dividend treatment (under sec. 304). TEFRA provided that the provisions relating to transfers to 80-percent controlled corporations would generally not apply to the extent of the nonstock consideration distributed. However, the language also applies to exchanges governed by the corporate reorganization provisions. Further, redemption treatment was made inapplicable where the property received consists of indebtedness assumed by the acquiring corporation or indebtedness to which the transferred stock is subject if such indebtedness (acquisition indebtedness) was incurred by the shareholder to acquire the transferred stock. Redemption treatment was made inapplicable even if the acquisition indebtedness was assumed in a transaction to which the nonrecognition rules would not apply (one in which the transferors own less than 80 percent of the acquiring corporation). Finally, under TEFRA, stock redemption treatment does not apply to certain minority shareholders who receive securities in an exchange in which stock in a bank is transferred to a newly formed bank holding company provided those who receive property in the exchange do not have control of the bank holding company.

Explanation of Provision

The bill clarifies that only the nonrecognition provision governing transfers to a corporation in which the shareholders have 80 percent control (sec. 351) would be made inapplicable to exchanges involving controlled corporations treated as redemptions. Thus, where the reorganization provisions apply, including those governing the treatment of exchanges by shareholders pursuant to a plan of reorganization, the rules of section 304(a) providing treatment as a stock redemption would not apply.

In order to prevent the "bail out" of earnings by purchasing stock from a related party with borrowed funds and later transferring the stock to a related corporation with the acquisition debt assumed, the bill restricts the exclusion from the rules providing stock redemption treatment for acquisition indebtedness to cases in which the indebtedness is incurred to purchase stock from a person whose stock ownership is not attributable, under section 318(a), to the person transferring the stock to the acquiring corporation. Attribution resulting from ownership of an option is to be ignored in applying this rule. Finally, the bill provides that where the shareholders receive property consisting of the assumption of acquisition indebtedness in a corporation in which their control is between 50 and 80 percent, the transaction would be subject to redemption and possible dividend treatment under section 304(a).

The bill clarifies that the assumption by a bank holding company of acquisition indebtedness will not be treated as property received by shareholders in control of the bank holding company for purposes of applying the rule excluding securities received by minority shareholders from the stock redemption rules. Thus the minority shareholders would not be subject to dividend treatment on the receipt of the securities.

c. Modification of constructive ownership rules in applying rules governing redemptions through use of related corporations

Present Law

Under the constructive ownership rules, generally a shareholder is treated as owning stock held by a corporation only if the shareholder directly or indirectly owns 50 percent or more in value of the stock of such corporation and only in proportion to his ownership in the corporation. Conversely, a corporation is generally treated as owning all the stock that is held by persons who are 50 percent or greater shareholders in the corporation. In applying the rules requiring redemption treatment for exchanges of stock for property involving commonly controlled corporations, these 50-percent threshold limitations on attribution of ownership do not apply. As a result, the stock redemption rules may apply when, for example, a corporation sells stock of a subsidiary to a subsidiary of another corporation if a person owns any stock in both the parent of the purchasing corporation and the selling corporation, even though such stock in each case is merely a portfolio investment. A consequence of treating the transaction under the stock redemption rules is that, under those rules, the transferred stock is treated as a contribution to the capital of the acquiring corporation. Concern has been expressed that this treatment precludes treatment of the stock acquisition as a purchase, thus disqualifying it as a qualified stock purchase for purposes of permitting elective asset acquisition treatment by the acquiring corporation (under section 338).

Explanation of Provision

The bill provides a *de minimis* rule that constructive ownership would not apply to and from a corporation and a shareholder owning less than 5 percent in value of the stock of the corporation, for purposes of determining whether or not control exists under section 304. Further, under the bill, where the stock owned by or for a shareholder is less than 50 percent in value of the corporation's stock, attribution of ownership from the shareholder to the corporation is limited to the proportion of the value of the corporation's outstanding stock owned by the shareholder. The bill conforms the analagous constructive ownership rule applicable to the receipt of preferred stock in certain transfers of stock to controlled corporations.

d. Disposition of certain preferred stock

Present Law

If, in lieu of the receipt of cash or other property, shareholders who transfer stock in a controlled corporation to another controlled corporation receive in exchange preferred stock in a transaction in which gain or loss is not recognized, subsequent disposition of the preferred stock may result in ordinary income to the shareholders, if receipt of cash in lieu of stock would have been treated as a dividend. The determination of the character of the hypothetical receipt of cash is made under the rules providing for stock redemption and possible dividend treatment when stock is sold to a commonly controlled corporation. This extension of the treatment generally applicable to preferred stock dividends to preferred stock received in an exchange with a controlled corporation to which the nonrecognition rules apply was adopted by TEFRA. However, the preferred stock affected by this rule may be disposed of in a stock redemption; whether ordinary income results from such redemption is determined by treating it solely as a distribution by the acquiring corporation. The acquiring corporation may be a corporation newly formed or may have little or no earnings and profits so that the distribution would not constitute a dividend.

Explanation of Provision

The bill provides that the dividend equivalence test applied with respect to a hypothetical distribution of cash will be applicable at the time of redemption or other disposition of the preferred stock (or stock whose basis is determined by reference to the basis of the preferred stock) as well as at the time of its receipt. Under this test, treatment of the redemption of the preferred stock as a dividend to the shareholders will be determined with reference to the earnings and profits of the corporation the stock of which was acquired as well as the acquiring corporation.

12. Completed contract method of accounting (sec. 612(l) of the bill and sec. 229 of TEFRA)

Present Law

TEFRA directed the Treasury Department to modify the income tax regulations relating to accounting for long-term contracts. Subsequently, on March 14, 1983, the Treasury Department issued proposed regulations in the Federal Register with respect to accounting for long-term contracts. Those regulations proposed waiving the estimated tax payment penalties for underpayments caused by certain provisions of regulations.[4]

Explanation of Provision

The bill would clarify that the Treasury Department has the authority to waive the penalties as proposed in the regulations.

13. Limitations on benefits and contributions under qualified plans (sec. 613(a) of the bill and sec. 415 of the Code)

Present Law

The Code provides overall limits on contributions and benefits under qualified plans, tax-sheltered annuities, and simplified employee pensions for employees of private and public employers. Under a defined benefit plan, before TEFRA, the inflation-adjusted 1982 limit on the annual benefit for an employee was generally the lesser of $136,425 or 100 percent of the employee's average compensation (consecutive high three years). Under a defined contribution plan, before TEFRA, the inflation-adjusted 1982 limit on the annual addition for an employee was generally the lesser of $45,475 or 25 percent of the employee's compensation for the year. If an employee participated in both a defined benefit and a defined contribution plan of an employer, the fraction of each separate limit used was computed and the sum of the fractions was limited to 1.4.

TEFRA generally reduced the overall limits on contributions and benefits under qualified pension, etc., plans, tax-sheltered annuity programs, and simplified employee pensions (SEPs) of private and public employers.

The dollar limit on the annual addition under defined contribution plans was decreased under TEFRA from $45,475 to $30,000, and the dollar limit on the annual benefit payable under defined benefit plans was decreased from $136,425 to $90,000. Beginning in 1986, these amounts will be adjusted for inflation. In addition, for participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limits used by each plan was reduced to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as applied to the percentage-of-compensation limits).

Under TEFRA, if retirement benefits provided by a qualified defined benefit pension plan begin before age 62, the benefit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62. Similarly, if retirement benefits under a defined benefit plan begin after age 65, the benefit may be increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65.

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[4] Prop. Treas. reg. sec. 1.451-3(g)(5).

The TEFRA provision reducing the limits on contributions and benefits is generally effective for years ending after July 1, 1982. For plans in existence on July 1, 1982, however, the provision is effective for years beginning after December 31, 1982. A special effective date was provided for plans maintained on the date of enactment (September 3, 1982) pursuant to one or more collective bargaining agreements between employee representatives and one or more employers.

Special transition rules were provided in connection with the reduced limits. Under TEFRA, a participant's current accrued benefit under a defined benefit pension plan is not reduced merely because TEFRA reduced the dollar limits on benefits payable under the plan. An individual's current accrued benefit is the benefit accrued as of the close of the last year beginning before January 1, 1983. No changes in the terms and conditions of the plan after July 1, 1982, may be taken into account in determining the current accrued benefit under the special transition rules.

TEFRA also provided a special, elective transitional rule for computing the defined contribution fraction in situations in which the employer maintains both a defined contribution plan and a defined benefit plan.

Explanation of Provision

The bill clarifies that the actuarial adjustments required by TEFRA for benefits paid prior to age 62 or after age 65 are applied to the dollar limit on annual benefits ($90,000) rather than to the benefit.

In the case of participants in collectively bargained plans in existence on the date of enactment, the bill provides that the current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1986. In addition, the bill provides that, in the case of a collectively bargained plan, changes in the terms and conditions of the plan made pursuant to a collective bargaining agreement reached prior to July 1, 1982, and ratified prior to September 3, 1982, may be taken into account for purposes of computing the current accrued benefit.

The bill clarifies that the special, elective transition rule for computing the defined contribution plan fraction is available only for plans that were in existence on or before July 1, 1982.

14. Loans to plan participants (sec. 613(b) of the bill and sec. 72 of the Code)

Present Law

TEFRA provided that any amount received (directly or indirectly) by a participant as a loan from (1) a qualified pension, etc., plan, (2) a governmental plan (whether or not a qualified plan), or (3) a tax-sheltered annuity contract is treated as a distribution to the participant unless certain requirements are met. For example, a loan that, by its terms, must be repaid within five years generally is not treated as a distribution if the amount of the loan, when added to the outstanding loan balance (principal plus interest) with respect to the employee under all plans of the employer, does not exceed the lesser of (1) $50,000, or (2) 50 percent of the present value of the employee's nonforfeitable accrued benefit under such plan (but not less than $10,000).

TEFRA did not repeal a provision of prior law under which the repayment of a loan from an H.R. 10 plan (a qualified plan covering a self-employed individual) by an owner-employee (a sole proprietor or an individual partner who owns more than 10 percent of a partnership) was treated as a contribution to the plan. Amounts treated as contributions under the rule were subject to the limit on deductions for contributions to H.R. 10 plans.

The TEFRA loan rules generally apply to loans made after August 13, 1982. Under a special transitional rule, however, a qualified refunding loan made after August 13, 1982, and before August 14, 1983, generally is not treated as a distribution on the date of the loan. A qualified refunding loan is a loan used to make a required principal payment on a loan that was outstanding on August 13, 1982, if that payment is required to be made before August 14, 1983.

Explanation of Provision

The bill clarifies that the 50-percent loan limit does not reduce the overall limit on loans below $10,000. Accordingly if, immediately after a loan, the outstanding loan balance is less than $10,000, the new loan rules would not cause the loan to be treated as a distribution even though the outstanding loan balance at that time exceeds 50 percent of the employee's nonforfeitable accrued benefit under the plan. TEFRA did not change prior law under which certain loans could be treated as distributions.

In addition, the bill provides that a loan to an employee from deductible employee contributions is treated as a distribution under the plan, regardless of the amount of the loan. In addition, the present value of an employee's nonforfeitable accrued benefit under the plan would not include any accrued benefit attributable to deductible employee contributions.

The bill repeals the provision that treats a repayment of a loan to an owner-employee as a contribution to the plan on behalf of the owner-employee.

Further, the bill clarifies the special transitional rule for qualified refunding loans by defining a required principal payment to include an amount paid under a loan payable on demand if the loan was outstanding on August 13, 1982.

15. Repeal of special qualification requirements (sec. 613(c) of the bill and secs. 72 and 402 of the Code)

Present Law

TEFRA generally eliminated distinctions in the tax law between qualified pension, etc., plans of corporations and those of self-employed individuals (H.R. 10 plans). TEFRA (1) repealed certain of the special rules for H.R. 10 plans, (2) extended other of the special rules to all qualified plans, including those maintained by corporate employers, and (3) generally applied the remainder of the special rules, with modifications, only to those plans (whether maintained by a corporate or noncorporate employer) that favor the employer's key employees (i.e., top-heavy plans).

TEFRA provided that a distribution to an individual who is (or was) a key employee and who has not attained age 59 1/2 or become disabled is subject to an additional 10-percent income tax. This additional tax is imposed on the income portion of a distribution attributable to accumulations or accruals made when the individual was a key employee in a top-heavy plan.

Explanation of Provision

The bill clarifies that the additional 10-percent income tax for distributions prior to age 59 1/2 is not to apply to a distribution to an owner-employee unless it is attributable to contributions paid on behalf of the individual while a key employee in a top-heavy plan.

The bill amends the rules relating to qualifying rollover distributions to provide that a rollover to a qualified pension, etc., plan is not permitted if any part of the distribution of a benefit is attributable to contributions made on behalf of the employee while a key employee in a top-heavy plan. The rule is necessary because of special restrictions that apply to these benefits. If a distribution to a self-employed individual is not attributable to contributions made while the individual was a key employee in a top-heavy plan, however, a rollover to a qualified pension, etc., plan or a qualified annuity plan is permitted.

16. Repeal of special limitations on deduction for self-employed individuals and subchapter S corporations (sec. 613(d) of the bill and secs. 72, 219, 401, 404, and 415 of the Code)

Present Law

TEFRA generally repealed most of the special deduction limits for contributions on behalf of a self-employed individual under a qualified defined contribution H.R. 10 plan, effective for taxable years beginning after December 31, 1983. In addition, TEFRA revised the definition of earned income of a self-employed individual so that the amount of earned income corresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules on deductions and limitations for qualified plans, the earned income of a self-employed individual is computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions.

TEFRA repealed the special rules applicable to qualified defined benefit pension plans providing benefits for self-employed individuals or shareholder-employees of a subchapter S corporation, effective for plan years beginning after December 31, 1983.

TEFRA revised the dollar limit ($30,000 for 1984) on employer contributions to a simplified employee pension (SEP) to correspond to the dollar limit on annual additions under a qualified defined contribution plan. TEFRA, however, did not increase the limit on employee deductions ($15,000) to conform with the higher limit on employer contributions.

Explanation of Provision

The bill provides that, for purposes of determining the maximum allowable deduction of a self-employed individual for contributions to a qualified plan, the earned income of the self-employed individual is determined without regard to the deductions allowable for contributions to a qualified pension, etc., plan.

The bill amends the effective date of the repeal of the special deduction rules for defined contribution H.R. 10 plans to clarify that the rules do not apply to a qualified defined benefit H.R. 10 plan.

The bill amends the limit on deductions by employees for employer contributions to SEPs to conform with the dollar limit on annual additions to qualified defined contribution plans. Accordingly, the bill raises the dollar limit on employee dedutions to $30,000.

The bill also repeals the following provisions relating to self-employed individuals:

(1) the rule relating to the return of excess contributions made on behalf of a self-employed individual prior to the due date of the annual return;

(2) the special limit on contributions by an employer on behalf of an owner-employee to pay premiums or other consideration for an annuity, endowment, or life insurance contract on the life of the owner-employee issued under an H.R. 10 plan;

(3) certain special deduction rules applicable to plans benefiting self-employed individuals or shareholder-employees; and

(4) the special limitation applicable to certain level premium annuity contracts under plans benefiting owner-employees.

17. Allowance of exclusion of death benefit for self-employed individuals (sec. 613(e) of the bill and sec. 101 of the Code)

Present Law

TEFRA provided that the exclusion from gross income of amounts received as death benefits by the beneficiary or estate of an employee is available with respect to any lump sum distribution under a qualified pension, etc., plan, a qualified annuity plan, or a tax-sheltered annuity paid on behalf of a self-employed individual.

Explanation of Provision

The bill provides that the exclusion from gross income of employee death benefits provided on behalf of a self-employed individual generally applies to amounts paid or distributed under a qualified pension, etc., plan. The bill would not change the rule providing that the exclusion is not available if (1) the employee (or self-employed individual) possessed, immediately before death, a nonforfeitable right to receive the amounts while living and (2) the distribution is not a lump sum distribution.

18. Special rules for top-heavy plans (sec. 613(f) of the bill and secs. 408 and 416 of the Code)

Present Law

TEFRA provided additional qualification requirements for plans that favor an employer's key employees (top-heavy plans). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account, (2) provide greater portability of plan benefits for plan participants by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are not key employees, and (4) reduce the aggregate limit on contributions and benefits for certain key employees.

An individual is a key employee of an employer if the individual is a participant in an employer plan and, at any time during the plan year or any of the four preceding plan years, (1) is an officer (in the case of a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000.

For any plan year for which a plan is a top-heavy plan, only the first $200,000 of any employee's compensation may be taken into account under the plan. Beginning in 1986, this $200,000 limit will be adjusted for inflation in the same manner applicable to the adjustment of the overall dollar limits on contributions and benefits under qualified pension, etc., plans.

Under TEFRA, a defined benefit pension plan is a top-heavy plan for a plan year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the plan year exceeds 60 percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the account balances of participants, who are key employees, for the plan year exceeds 60 percent of the sum of the account balances of all employees under the plan.

If a plan is a member of a group of plans that is required to be aggregated for purposes of the rules for top heavy plans, the plan's status is determined by the status of the group. Accordingly, if the plan is a member of a group that is not top heavy, no plan in the group is top heavy even though the particular plan, standing alone, would be top heavy. Similarly, if the group is top heavy, each plan in the group is top heavy even though the particular plan, standing alone, is not top heavy.

Under a 5-year lookback rule, the present value of the cumulative accrued benefit of a participant in a defined benefit pension plan or the account balance of a participant in a defined contribution plan generally includes any amount distributed with respect to the participant under the plan within the five-year period ending on the determination date (including lump-sum distributions and distributions made before the date of enactment or before the plan became top-heavy).

Explanation of Provision

The bill revises the definition of a key employee to include any employee, rather than any participant in an employer plan, who has the requisite relationship to the employer. An employee includes a former employee who must be considered under the five-year lookback rule. In addition, the bill provides that, for purposes of determining the ten employees owning the largest interests in the employer, (1) only employees with annual pay in excess of the dollar limit for the year on annual additions to qualified defined contribution plans ($30,000 for 1984) are taken into account as key employees and (2) if two employees have the same interest in the employer, the employee with greater annual compensation is treated as having a larger interest. Further, the bill clarifies that the determination of the amount of an employee's interest in an employer for purposes of determining the top-ten owners, 5-percent owners, or 1-percent owners is determined without regard to the aggregation rules of sections 414(b), (c), or (m).

Under the bill, the requirement that the employer make a minimum contribution on behalf of each participant who is not a key employee applies to a SEP if the SEP arrangement is top-heavy.

The bill clarifies that distributions under a terminated plan are taken into account under the 5-year lookback rule in determining the top heavy status of plans maintained by an employer.

The bill provides that the $200,000 limit on compensation taken into account under SEPs will be adjusted for inflation at the same time and in the same manner as the adjustments to the overall dollar limit on annual additions under a qualified defined contribution plan. In addition, the bill clarifies that no adjustment will be made to the $200,000 limit on compensation taken into account under the rules for top-heavy plans until adjustments are made to the overall dollar limits on contributions and benefits.

19. Required distributions for qualified plans (sec. 613(g) of the bill and sec. 401 of the Code)

Present Law

TEFRA extended to all qualified plans the requirement that the entire interest of an employee must be distributed not later than (1) the taxable year in which the participant attains age 70-1/2, or (2) if later, the year in which the participant retires. Alternatively, distributions must begin no later than such taxable year and must be made, pursuant to Treasury regulations, over the life of the participant (or lives of the participant and the participant's spouse), or over a period not exceeding the life expectancy of the participant (or the life expectancies of the participant and the participant's spouse). In addition, a top-heavy plan must provide that distributions to an individual who is a key employee will commence not later than the taxable year in which the key employee attains age 70-1/2 whether or not the key employee separates from service or applies for benefit payment in that year. Under present law, the entire interest of an employee does not include death benefits that are excluded from a beneficiary's gross income under section 101.

TEFRA extended to all qualified plans certain rules for post-death distributions. If a participant or the participant's surviving spouse dies before the entire interest in the plan is distributed, amounts payable to a beneficiary who is not the participant's surviving spouse generally must be paid to the beneficiary within five years after the participant or surviving spouse dies. The required distribution rules generally apply for plan years beginning after December 31, 1983. A special transition rule, however, exempts certain distributions made pursuant to employee designations if the designation is made before January 1, 1984.

Explanation of Provision

The bill clarifies that, for purposes of the rules requiring distributions before death, distributions may be made to the participant and a nonspouse beneficiary even though the measuring lives for a permissible payment period are those of the participant or the participant and spouse.

Under the bill, an exception is provided to the general rule requiring distributions to be paid within five years after the death of an employee or an employee's surviving spouse. Under the bill, the 5-year limit does not apply if the distribution commences not later than one year after the death of the employee or the employee's surviving spouse and is paid to a qualified beneficiary. Under Treasury regulations, payments must be made over a qualified period.

In general, the bill provides that a qualified beneficiary includes any individual who (1) was a dependent (sec. 152) of the employee or the employee's surviving spouse for any two of the last five taxable years, or (2) is a former spouse of the employee. For purposes of determining dependency, if a child's parents are divorced, and the child is a dependent of either or both of the divorced parents, then the child is treated as a dependent of each divorced parent. Also, social security benefits paid to a beneficiary are disregarded. The Committee intends that a plan administrator may rely in good faith on the written representations of a beneficiary as to the beneficiary's status as a dependent or former spouse.

The qualified period over which payments may be made to a qualified beneficiary generally does not end before the later of (1) five years after the date of death of the decedent, or (2) the life expectancy of an individual with an age equal to the age of the decedent at the time of death. Payments to a beneficiary who is permanently and totally disabled may be paid over the life expectancy of the beneficiary or a term certain not extending beyond the life expectancy of the beneficiary. Under the bill, in the case of a qualified beneficiary who is under age 22 at the time of the employee's death, payments need not commence prior to the time the beneficiary attains age 22 and the qualified period does not, in any case, end before the beneficiary attains age 27. The same rules apply if the benefits are payable after the death of the employee's spouse.

The bill provides that the special transition rule for employee designations does not expire until the first day of the first plan year beginning on or after January 1, 1984. In addition, the bill would clarify that if a plan provides for a specific method of distribution in the absence of an employee election of another method, such a default option is treated as an employee designation under the special transition rule. This default option is treated as an employee designation even if there is only one method of distribution permitted under the plan. Further, in the case of a collectively bargained plan, the transition period for employee designations does not expire until the first day of the first plan year beginning on or after the earlier of (1) the date on which the last of the collective bargaining agreements relating to the plan terminates or (2) January 1, 1986.

Under the bill, in the case of a government plan, the effective date is delayed until plan years beginning after December 31, 1985, in order to provide adequate time for the employer to amend the plan. Corresponding changes are made to the expiration date of the special transition rule.

20. Required distributions in case of individual retirement plans (sec. 613(h) of the bill and sec. 408 of the Code)

Present Law

TEFRA revised the rules relating to distributions from an individual retirement account or annuity (IRA) after the death of the individual on whose behalf the IRA was established. In addition, TEFRA repealed the rules under which any beneficiary of an individual on whose behalf an IRA was established (or any beneficiary of the surviving spouse [illegible] such an individual) effectively could elect to treat the inherit[illegible]s one established on the beneficiary's own behalf.

The TEFRA provision relating to the treatment of inherited IRAs is effective for [illegible] years beginning after December 31, 1983.

Explanation of Provision

The bill clarifies that the provision applies with respect to individuals dying after December 31, 1983.

21. Existing personal service corporations liquidating in 1983 or 1984 (sec. 613(i) of the bill and sec. 247 of TEFRA)

Present Law

TEFRA provided a transitional rule under which personal service corporations may, during 1983 or 1984, complete a one-month liquidation under section 333 without the corporation incurring tax on its unrealized receivables.

Explanation of Provision

The bill clarifies that this transition rule is available only to corporations that were in existence on September 3, 1982 (the date of enactment of TEFRA).

22. Nondiscriminatory coordination of defined contribution plans with OASDI (sec. 613(j) of the bill and sec. 408 of the Code)

Present Law

TEFRA extended to all defined contribution plans a prior-law rule for qualified H.R. 10 plans under which the tax rate and wage base applicable to employers for old age, survivors, and disability insurance (OASDI) under social security are the maximum rate and base for determining the amount by which employer contributions can be reduced under qualified plans that are integrated with social security.

Explanation of Provision

The bill provides that, if an employer does not maintain an integrated plan at any time during the taxable year, OASDI contributions may be taken into account as contributions by the employer to an employee's simplified employee pension (SEP). This rule applies, however, only if OASDI contributions are taken into account with respect to each employee maintaining a SEP.

23. Profit-sharing plan contributions on behalf of disabled employees (sec. 613(k) of the bill and sec. 415 of the Code)

Present Law

TEFRA permitted an employer to elect to continue deductible contributions to a profit-sharing plan on behalf of an employee who is permanently and totally disabled. The contributions are deductible, however, only if contributions are nonforfeitable when contributed.

Explanation of Provision

The bill clarifies that the election is available for contributions to profit-sharing and stock bonus plans. In addition, the bill clarifies that only those contributions that are the subject of the employer's election must be nonforfeitable when made under the special rule.

24. Attorney's fees (sec. 614(b) of the bill and sec. 7430 of the Code)

Present Law

TEFRA added provisions allowing awards of attorney's fees to taxpayers under certain circumstances in tax cases commenced after February 28, 1983, in any United States court or the Tax Court. On October 1, 1982, (after enactment of TEFRA), the U.S. Court of Claims was reorganized, creating a new United States Claims Court as an Article I court. Because of this reorganization, the question has arisen whether the Claims Court is a "court of the United States" for purposes of the attorney's fee provisions.

Explanation of Provision

The bill clarifies that the attorney's fee provisions of TEFRA apply in tax cases in the Claims Court.

25. Withholding on pensions, annuities, and certain other deferred income (sec. 614(c) of the bill and secs. 31, 3405, and 6652 of the Code)

Present Law

TEFRA provided that payors generally are required to withhold tax from a designated distribution (the taxable part of a payment made from or under a pension, profit-sharing, stock bonus, or annuity plan, an IRA, a commercial annuity contract, or an employer deferred compensation plan if the distribution is not otherwise considered wages). Recipients may elect, for any reason, not to have the withholding rules apply to any distribution. Payors are required to notify recipients of their right to elect not to have the withholding rules apply.

Explanation of Provision

The bill provides a credit against income tax for the amounts withheld under the pension withholding provisions.

Under the bill, no amount would be required to be withheld if a distribution consists only of employer securities of the employer corporation and cash in lieu of fractional shares of employer securities. The amount of cash received in the distribution may not exceed $200. The bill clarifies that the taxable part of a nonperiodic distribution paid by reason of death under a qualified pension, etc., plan, or a tax-sheltered annuity, is determined by taking into account the $5,000 death benefit exclusion provided in section 101(b), whether or not the exclusion is allowable.

The bill clarifies that the pension withholding rules do not apply to amounts paid to nonresident aliens if the amounts are subject to the withholding of tax on nonresident aliens or would be subject to such withholding but for a tax treaty. Further, the bill provides a penalty for failure to give the notice to recipients required under the pension withholding rules. The penalty applies unless it is shown that the failure is due to reasonable cause and not willful neglect. The penalty is equal to $10 for each failure, up to a maximum during any calendar year of $5,000.

26. Partnership audit (sec. 614(g) of the bill and sec. 6233 of the Code)

Present Law

The tax treatment of any partnership item, under the rules adopted in TEFRA, is required to be determined at the partnership level. A comparable requirement applies in the case of subchapter S corporations. A partnership return or an S corporation may be filed for a taxable year and it may thereafter be determined that the filing entity is not a partnership or an S corporation, respectively, or that there is no entity for the taxable year with respect to which the return was filed.

Explanation of Provision

Under the bill, to the extent regulations provide, the partnership level determination requirement and the comparable requirement for S corporations apply when a partnership return or S corporation return, respectively, is filed, although it is thereafter determined that the filing entity was not a partnership or S corporation, or that no entity existed for the taxable year as to which the return was filed.

27. Clerical amendments

Amendments are also made to correct several clerical errors and correct cross references.

B. Technical Corrections to the Subchapter S Revision Act of 1982

1. Corporate liquidations, etc. (sec. 621(a) of the bill and proposed sec. 1363(e) of the Code)

Present Law

The Subchapter S Revision Act of 1982 (the "Act") provided that gain is recognized on the distribution of appreciated property by an S corporation with respect to its stock. The committee reports state that this rule does not apply in the case of a complete liquidation.

Explanation of Provision

The bill adds clarifying language making this rule inapplicable in the case of a complete liquidation of an S corporation, or to the distribution of stock by an S corporation in a reorganization where the receipt of that stock is tax-free to the shareholder (by reason of sec. 354, 355, or 356). It is intended both that a liquidating distribution by an S corporation will be a nonrecognition transaction at the corporate level, and also that the nonrecognition provisions of section 337 will continue to apply to the sale or exchange of property after a plan of complete liquidation has been adopted by an S corporation.

As under present and prior law, gain or loss will be recognized by the shareholder with respect to his or her S corporation stock on receipt of a distribution in complete liquidation (under the rules of secs. 331 or 333). The amount of gain or loss recognized to the shareholder will not be affected by any gain or loss which is not recognized at the corporate level.

2. Treatment of discharge of indebtedness (sec. 621(b) of the bill and sec. 108 of the Code)

Present Law

Generally, a taxpayer realizes income when its debts are discharged at less than the face amount of the debt. However, if the debt was incurred by a corporation, the taxpayer may elect to reduce certain tax attributes in lieu of recognizing income.

Explanation of Provision

In order to treat all shareholders in the same manner, the bill provides that the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses which are not allowed by reason of any shareholder's basis limitation) are made at the corporate level. Also, the bill would provide that where a debt is contributed to an S corporation by a shareholder as a contribution to capital after December 31, 1980, corporate income would not result to the extent that the basis of the debt had previously been reduced by the pass-through of losses from the corporation.

3. Treatment of inactive subsidiaries (sec. 621(c) of the bill and sec. 1361(c)(6) of the Code)

Present Law

Under present law, an S corporation may not own a subsidiary corporation other than an inactive subsidiary. An inactive subsidiary is defined as a corporation which has not begun business before the close of the taxable year and which has no taxable income for the period included within the S corporation's taxable year.

Explanation of Provision

The bill eliminates the taxable income test and instead would provide that a subchapter S election would terminate, by reason of the subsidiary's becoming active, on the first day during the S corporation's taxable year the subsidiary has gross income. This rule prevents a termination of the subchapter S election from occurring retroactively to the beginning of the taxable year (which is generally prohibited) by reason of the subsidiary's having any taxable income. For purposes of applying this gross income test, contributions to the corporation's capital by a shareholder would not be treated as gross income.

4. Treatment of worthless debt (sec. 621(d) of the bill and sec. 1367(b) of the Act)

Present Law

The Act provided that corporate losses which pass through to the shareholders are to be taken into account prior to taking into account the deduction for worthless stock.

Explanation of Provision

The bill provides the same rule where the shareholder's debt in the corporation becomes worthless. Thus, for example, where a shareholder has no basis in his or her S corporation stock but has basis in debt owed by the corporation and that debt becomes worthless, corporate losses for the year will be allowed to the shareholder; these losses will reduce the shareholder's basis in the debt, which in turn will reduce the amount of the short-term capital loss (under sec. 166(d)) for the worthless debt.

5. Investment tax credit recapture (sec. 621(e) of the bill and sec. 1371(d) of the Code)

Present Law

The Act provided that the recapture of the investment tax credit for credits claimed in years prior to becoming an S corporation is to be made at the corporate level.

Explanation of Provision

The bill clarifies that an S corporation's accumulated earnings and profits will be reduced by the amount of investment credit recapture tax (sec. 47) imposed on the corporation with respect to these credits, since the earnings and profits were not previously reduced by the amount of tax savings attributable to the credit.

6. Qualified subchapter S trusts (sec. 621(f) of the bill and sec. 1361(d) of the Code)

Present Law

Present law allows certain trusts which distribute, or are required to distribute, income currently to elect to be treated as a "qualified subchapter S trust" which may be a shareholder in an S corporation. This election may be retroactive for up to 60 days.

Explanation of Provision

The bill increases this period to 75 days, to generally conform to the time provided the corporation to make a subchapter S election. Also, the bill clarifies that the disqualification of a trust by reason of the failure to meet the distribution requirements will be effective on the first day of the first taxable year after this requirement is not met.

7. Accounting treatment where election terminates (sec. 621(g) and (h) of the bill and sec. 1362 of the Code)

Present Law

Under present law, the items of income, loss, etc. for the entire taxable year in which a subchapter S election is terminated are pro-rated between the short subchapter S year and the short regular corporate year on a daily basis, unless all persons who are shareholders at any time during the year consent to closing the corporate books at the end of the subchapter S year.

Explanation of Provision

The bill provides that the election to "close the books" may be made if all the shareholders owning stock during the short subchapter S year and all shareholders owning stock on the first day of the short subchapter C year consent to the election. Also, under the bill, if a corporation makes a qualified stock purchase of the stock of an S corporation and makes an election under section 338, all the recapture income resulting from the election will be reported in the corporation's subchapter C return. As a result, the selling shareholders will not take this recapture into account on their individual returns.

8. Passive income rules for 1982 (sec. 621(i) of the Code and sec. 6(b) of the Act)

Present Law

Under the Act, the amendments to the passive income rules, preventing a subchapter S election from terminating by reason of excess passive income for any single taxable year, were made effective for taxable years beginning after December 31, 1981.

Explanation of Provision

The bill provides that a corporation can elect to have the new passive income rules apply only for taxable years beginning after December 31, 1982, the general effective date for the Act. Thus, a corporation with excess passive income under the rules of prior law for its taxable year beginning in 1982 can elect to terminate its subchapter S election rather than paying both a corporate and shareholder tax on that income. If an election under this provision is made causing the termination of the subchapter S election, the corporation cannot re-elect subchapter S status within 5 years without the consent of the Internal Revenue Service.

9. Attribution (sec. 621(j) of the Act and sec. 318 of the Code)

Present Law

Under present law, in applying attribution of ownership rules under section 318, a partnership is deemed to own proportionately stock owned by the partnership, and the partnership is deemed to own all the stock owned by the partners. In the case of a corporation, attribution to and from shareholders occur only with respect to shareholders owning 50 percent or more in value of the corporation's stock.

Explanation of Provision

The bill provides that the attribution of stock to or from an S corporation and its shareholders would apply in the same manner as if the S corporation (and its shareholders) were a partnership (with partners). Thus, attribution will occur to and from shareholders owning less than 50 percent of the corporation's stock.

10. Certain short taxable years (sec. 621(l) of the bill and sec. 1362(b) of the Code)

Present Law

Under present law, a subchapter S election for a taxable year may be made during the first 2 1/2 months of the taxable year (sec. 1362(b)(1)(B)).

Explanation of Provision

The bill provides that a corporation can make the election within 2 1/2 months from the beginning of a taxable year although the taxable year is of less than 2 1/2 months duration.

11. Taxable year of existing S corporations (sec. 621(m) of the bill and sec. 1378 of the Code)

Present law

Under present law, an S corporation which had an election in effect for a taxable year which includes December 31, 1982, may not retain that taxable year after there has been a change in ownership of more than 50 percent of the stock after December 31, 1982. Acquisition by reason of death, gift or certain buy-sell agreements are not treated as change in ownership.

Explanation of provision

The bill clarifies that the ownership change rules apply to any corporation which made an election before October 19, 1982, where that election was effective for a taxable year beginning in 1983.

12. Clerical amendments

The bill also makes several clerical amendments to the Act.

C. Technical Corrections to Miscellaneous Provisions

1. Tax preference for low-income housing (sec. 622(a)(1) of the bill and sec. 57 of the Code)

Present Law

The Technical Corrections Act of 1982 added a provision to clarify that the amortization of low-income housing under section 167(k) remained a tax preference, but erroneously added that provision to subparagraph (A) of section 57(a).

Explanation of Provision

This bill moves that provision to subparagraph (B) of section 57(a), relating to the tax preference for 15-year real property.

2. Foreign currency contracts (sec. 622(a)(2) and (4) of the bill and sec. 1256(g) of the Code)

Present Law

The Technical Corrections Act of 1982 provided that certain foreign currency contracts entered into after May 11, 1982 (or earlier, if certain elections were made) will be treated as regulated futures contracts and therefore be taxed on the marked-to-market system with a maximum tax rate of 32 percent. In order for a contract to qualify as a foreign currency contract, the contract must require delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts.

Explanation of Provision

Because certain contracts may call for a cash settlement by reference to the value of the foreign currency rather than actual delivery of the currency, the bill provides that the delivery of a foreign currency requirement is met where the contract provides for a settlement determined by reference to the value of the foreign currency.

The bill also permits taxpayers to elect to have the regulated futures contract rules apply only to contracts entered into after January 12, 1983, the date of enactment of the Technical Corrections Act of 1982.

3. Effective date of corporation acquisition provision (sec. 622(a)(3) of the bill and sec. 306(a)(8) of TEFRA)

Present Law

The Technical Corrections Act of 1982 clarified that any recapture income required to be reported as the result of an election to treat the purchase of corporate stock as the sale and purchase of the corporate assets generally is not reported on a consolidated return. Instead, the income is reported on the target corporation's separate return. The new TEFRA provision allowing an election to treat stock purchases as asset purchases was effective for purchases on or after September 1, 1982. A transitional rule was provided by the Technical Corrections Act to require reporting of the recapture income on the selling corporation's consolidated return in circumstances where the contract was negotiated on the contemplation that the recapture income would be reported on the selling corporation's consolidated return, and where the stock was purchased pursuant to a binding contract entered into on or after the date of enactment of TEFRA (September 3, 1982) and before the date of enactment of the Technical Corrections Act. The transitional rule is inapplicable where the contract was entered into before September 3, 1982, notwithstanding that it was contemplated that the new TEFRA rules would apply.

Explanation of Provision

The bill makes the special transitional rule requiring recapture income to be reported on a selling corporation's consolidated return applicable to contracts entered into on or after September 1, 1982 (the effective date of the TEFRA election provision), rather than on or after September 3, 1982 (the date TEFRA was enacted into law).

4. Coordination of certain amendments made by the Highway Revenue Act of 1982 and Public Law 97-473 (sec. 622(b) of the bill)

Present Law

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax exempt under section 103 and that therefore the shareholders of regulated investment companies holding those obligations qualify for tax-free treatment on the distributions of the interest on those obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to P.L. 97-473, the question arises whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

Explanation of Provision

The bill clarifies that Public Law 97-473 did not repeal the exempt interest provision added by the Highway Revenue Act.

5. Principal campaign committees (sec. 622(c) of the bill and sec. 527(h) of the Code)

Present law

Under present law, the principal campaign committee of a candidate for Congress is taxed by using the graduated corporate rates. The principal campaign committee is the committee designated by the candidate.

Explanation of Provision

The bill provides that if the candidate has only one campaign committee, that committee will be treated as the principal campaign committee without the necessity of a designation.

D. Technical Corrections to Highway Revenue Act of 1982

1. Application of retail truck and trailer excise tax to vehicles including used parts (sec. 631 of the bill and sec. 4052 of the Code)

Present Law

The Highway Revenue Act repealed the prior 10-percent manufacturers excise tax on certain trucks and trailers and imposed the tax as a retail excise tax. The new tax is imposed at a 12-percent rate on the first retail sale of taxable trucks and trailers.

Explanation of Provision

The bill clarifies that the value of any used component included in a taxable truck or trailer (if furnished by the first user of the taxable vehicle) is excluded in determining the retail price of (and thereby the excise tax on) the truck or trailer.

2. Application of gasoline excise tax to gasohol (sec. 632 of the bill, secs. 4081(c) and 6427 of the Code, and sec. 521(a) of the Act)

Present Law

The Highway Revenue Act provides a 5-cents-per-gallon exemption for gasohol from the 9-cents-per-gallon gasoline excise tax.

Explanation of Provision

The bill clarifies that the exemption applies to the gasohol mixture, and not solely to the gasoline component of the mixture. A conforming amendment is made to the floor stocks tax imposed on certain gasohol held for sale on April 1, 1983.

3. Certain chain operators of retail gasoline stations treated as producers (sec. 633 of the bill and sec. 4082(d) of the Code)

Present Law

The Highway Revenue Act imposed a tax of 9 cents per gallon on the sale of gasoline by a producer or importer. For purposes of this tax, the term "producer" includes wholesale distributors who (1) sell gasoline to producers, to retailers, or to users who purchase the gasoline in bulk quantities for delivery into bulk storage tanks and (2) who elect to be so treated. These distributors (jobbers) may purchase gasoline tax-free for sale to independent dealers or (in the case of distributor-owned retail gasoline stations) for retail sale, the tax being imposed upon such later sale.

Explanation of Provision

The bill provides that, for purposes of the gasoline tax, wholesale distributors include chain operators who (1) purchase gasoline from a producer and distribute the gasoline to 10 or more retail stations under common management with such operator and (2) who elect to be so treated. These distributors will be entitled to purchase gasoline tax-free for sale at the commonly-managed retail stations, the tax being imposed upon such later sale. For purposes of this rule, retail sale of the same brand of gasoline is not sufficient to indicate common management.

4. Floor stocks refunds for tax-reduced tires (sec. 634(a) of the bill and sec. 523(b) of the Highway Revenue Act)

Present Law

The Highway Revenue Act provides for refund of certain previously-paid manufacturers excise taxes on articles on which tax is repealed.

Explanation of Provision

The bill clarifies that floor stocks refunds also are available with respect to tires on which the excise tax is reduced, but not repealed, on January 1, 1984. The refund is limited to the reduction in tax.

5. Collection of excise tax on noncommercial aviation gasoline (sec. 634(c) of the bill and new secs. 4082(e) and 6427(j) of the Code)

Present Law

Present law provides for a tax of 12 cents per gallon on gasoline used in noncommercial aviation aircraft. The tax consists of two parts: a 9-cents-per-gallon tax on gasoline collected at the manufacturer's level (sec. 4081) plus a 3-cents-per-gallon tax collected at the retail level (sec. 4041(c). A tax of 14 cents per gallon on nongasoline fuels (e.g., jet fuel) used by noncommercial aviation is collected at the retail level.

Explanation of Provision

The bill provides that the 12 cents per gallon excise tax on gasoline used in noncommercial aviation aircraft shall be collected at the retail level effective January 1, 1984. The aviation gasoline dealer (under new sec. 4082(e)) is to be treated as a "producer" of gasoline and thus able to purchase such gasoline tax-free from the gasoline manufacturer or producer. An aviation gasoline dealer includes any person who regularly sells gasoline to owners, lessees, or operators of aircraft for use as fuel in such aircraft in noncommercial aviation.

An aviation gasoline dealer must register with the IRS in order to purchase gasoline tax-free. If the gasoline is later used or resold as fuel for other than noncommercial aviation aircraft, the user or seller must then pay the appropriate tax (i.e., 9 cents per gallon tax if used in a highway motor vehicle or in a motorboat).

6. Floor stocks refunds for retread tires (sec. 634(d) of the bill, sec. 523(b) of the Highway Revenue Act, and sec. 4072 of the Code).

Present Law

The Highway Revenue Act repeals, effective January 1, 1984, the tax of 5 cents per pound on tread rubber used in recapping or retreading highway tires. The Act provides for floor stocks refunds with respect to tread rubber on which the tax was previously paid and which remains in inventory on December 31, 1983.

Explanation of Provision

The bill provides that tread rubber which has been placed on retread tires prior to January 1, 1984, qualifies for a floor stocks refund. Only one such refund per tire may be received.

7. Other technical and conforming changes (secs. 634(b), (c), and (e)-(h) and 635 of the bill, secs. 513(c), 521(c), and 523(b) of the Highway Revenue Act, and secs. 4051, 4053, 4061, 4063, 4071, 4073, 4082, 4216, 4218, 4221, 4227, 4481, 6412, and 6416 of the Code)

Explanation of Provisions

The bill restates as part of the new truck and trailer retail excise tax the exemptions previously provided under the repealed manufacturers excise tax.

The bill clarifies that refunds on tax paid on articles used as components in the manufacture of later articles are generally to be paid to the person who paid tax on the later article rather than the person who paid tax on the component.

The bill clarifies that the liability of installers for the truck and trailer retail excise tax on certain parts and accessories installed on taxable vehicles within six months of their purchase is secondary to the liability of the truck or trailer owners.

The bill clarifies that penalties applicable to the highway excise taxes also apply to the floor stocks taxes imposed by the Highway Revenue Act.

The bill clarifies two provisions relating to the heavy vehicle use tax. First, the bill clarifies that owner-operators eligible for a one-year delay in the increased heavy vehicle use tax rates will be subject to a full year's tax at the present law rates during 1984 (rather than a partial year's tax because of the previously scheduled expiration date of September 30, 1984). Second, the bill provides that no inference is to be drawn from the 1982 amendments with respect to the taxation of trailers based on their "customary use" for periods before the effective date of those amendments.

Further, the bill repeals provisions of the Code made obsolete by the Highway Revenue Act.

E. Technical Corrections to the Social Security Amendments of 1983 and Related Legislation

1. Foreign work test: Withholding from auxiliary on account of work performed by a retired worker (sec. 641(g) of the bill and sec. 203(d)(1) and (2) of the Act)

Present law

The Social Security Amendments of 1983 (P.L. 98-21) changed the foreign work test to provide that a retirement, auxiliary, or survivor beneficiary will have his benefit withheld for each month in which he is under age 70 and works for more than 45 hours in noncovered remunerative activity outside the United States. However, the 7-day work test which applied to all beneficiaries under prior law continues to apply only with respect to withholding an auxiliary benefit because of work performed by the retired worker.

Explanation of Provision

In order to avoid the anomalous situation of having two different foreign work tests, the bill provides that auxiliary benefits will be withheld due to noncovered work performed by a retired worker outside the United States on the same basis as primary benefits.

2. FICA treatment of employer pickup of employee contributions under State and local retirement plans (secs. 641(i)(2) and 643(i)(9) of the bill, sec. 209 of the Act, and secs. 3121 and 3306 of the Code)

Present Law

Prior to the Social Security Amendments of 1983, certain employer payments ("pickups") of employee contributions under a State or local retirement plan were treated as subject to FICA and FUTA only if the payments were made under a salary reduction arrangement. Under the Amendments, all such employer payments are subject to FICA and FUTA.

Explanation of Provision

Congress intended, in the Amendments, merely to codify the prior law treatment of employer pickups. Thus, the bill amends the provision so that employer pickups are taxable, for FICA and FUTA purposes, only if the pickup is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise).

3. Social Security coverage of Federal workers (secs. 641(j)(2) and 643(i)(4) of the bill and sec. 210(a)(5)(B) of the Social Security Act and sec. 3121(b)(5)(B) of the Code)

Present Law

The Social Security Amendments of 1983 provided social security coverage for newly hired Federal civilian employees effective with remuneration paid after December 31, 1983. Persons continuously in the employ of the United States since December 31, 1983 (or with a break in such employment of 365 days or less) will not be covered.

Due to a drafting oversight, it is possible under this provision for a Federal employee who is covered under social security and who has a break in service of 365 days or less to be excluded from coverage upon return to Federal employment. For example, a person who is in the military service (which is covered under social security) as of December 31, 1983 who leaves the service and within 365 days assumes a position under the civil service retirement system would be exempt from social security coverage in the new Federal job. This result is unintended and inconsistent with the intent of the provision which is to expand the coverage of Federal employees by the social security system. In addition, the use of the phrase "remuneration paid" in the effective date would have the effect of covering some 1983 earnings for which payment is not actually made until 1984, which was not the intent of the provision.

Explanation of Provision

In order to prevent Federal employees who had been previously covered under social security from losing coverage as a result of a break in service of 365 days of less, the bill provides that only continuous noncovered Federal employment since December 31, 1983 is a basis for exclusion from social security coverage. The bill also corrects the effective date language to refer to "service performed" after December 31, 1983.

4. Basis for calculation of alternate annual cost-of-living adjustments (secs. 641(k)(4) and (5) of the bill and sec. 215(i)(5) of the Act)

Present Law

The Social Security Amendments of 1983 provided an alternative basis for the calculation of the annual cost-of-living adjustment to be paid in years when the trust fund balance is below a given percentage (15 percent at the beginning of years from 1985 through 1988, 20 percent thereafter). In any such year, the adjustment would be based on the lower of the CPI increase or the increase in average wages. The provision also requires that a "catch-up" payment be made at the point the trust funds again accumulate a reserve of at least 32 percent, to increase overall benefit levels to the extent necessary in order to compensate for losses resulting from the lower adjustment being paid. These payments can be made only to the extent that a fund ratio of at least 32 percent is maintained.

Due to a drafting oversight, the provision does not provide the authority necessary to round these catch-up payments in the same manner as all other social security benefits are rounded. The provision also could be interpreted as basing the calculation of the amount of the catch-up increase on a period of years including the year of the catch-up itself, rather than on the period ending with the year prior to the catch-up, as was intended and is stated elsewhere in the provision. In addition, the provision could be interpreted to allow a much higher catch-up payment than intended for persons who are eligible for retirement benefits long after the year of a lower benefit increase, but who were eligible for disability benefits during the year the lower increase was paid. Finally, the provision is not precise as to the description of the catch-up payment as an actual percentage.

Explanation of Provision

In order to clarify these ambiguities, the bill provides the necessary authority to round benefits, specifies that the catch-up payment will be based on the period of years preceding the year of the catch-up payment, and specifies that the calculation for an individual's entitlement to a catch-up payment is to be based on the year of eligibility for the benefit on which the catch-up increase is paid, and is to be cleraly expressed as a percentage.

5. Benefits of persons receiving pensions from noncovered employment (sec. 641(k)(1) of the bill and sec. 215(a) of the Act)

Present Law

The Social Security Amendments of 1983 provided for a different benefit formula to be used in computing social security benefits for persons receiving pensions from employment not covered by social security. Because of a drafting oversight, the language of the provision may result in exemption from the "windfall" formula of anyone who was eligible for any type of social security benefit at any time prior to eligibility for retirement benefits (e.g., during a brief period of disability.) Also, this language may result in unintended anomalous treatment of earnings for persons who work after age 62.

Explanation of Provision

The bill clarifies the definition of eligibility for the windfall benefit formula to make certain that all those becoming eligible for social security benefits after 1985 (provided they had not become eligible for their noncovered pension prior to that time) will have the new formula applied to them, and corrects the unintended, anomalous treatment of earnings after age 62.

6. Gender-based distinction concerning divorced husbands (sec. 641(l)(1) of the bill and sec. 216(f) of the Act)

Present Law

Under present law, a divorced woman is deemed to be divorced throughout the month in which she becomes divorced. Divorced husbands are not so deemed.

Explanation of Provision

While the Social Security Amendments of 1983 sought to eliminate all gender-based distinctions in the Social Security Act, this gender-based distinction was not eliminated by those Amendments. Consistent with the intention of the 1983 amendments, the bill deems a divorced husband to be divorced throughout the month in which he becomes divorced.

7. Financing of noncontributory military wage credits (sec. 641(n) of the bill and sec. 229(b) of the Act)

Present Law

The Social Security Amendments of 1983 changed the method of financing post-1956 noncontributory military wage credits by providing for a lump-sum payment to be made to the OASDHI trust funds from the general fund based on an amount estimated to be equivalent to the OASDHI employer-employee taxes attributable to such wage credits for the period 1957-83, accumulated with interest.

The law also provides that within 1 year after the date of the lump-sum transfer (which occurred on May 20, 1983), the amount is to be revised based on data which become available during that year. However, due to the timing of annual wage reporting, the actual amount of 1983 deemed military service wage credits will not become available until early in 1985 and, therefore, cannot be used to adjust the lump-sum amount.

The 1983 amendments also provided that in the future the trust funds would be paid annually for the OASDHI employer-employee taxes on deemed wage credits attributable to military service in years after 1983. These annual payments may be adjusted in subsequent years to account for actual experience but not for years before 1984. Thus, under current law, there will be no opportunity to revise the payment based on estimates of the amount of 1983 deemed wage credits in order to reflect actual experience.

Explanation of Provision

In order to ensure that the OASDHI trust funds are paid the correct amount for employer and employee taxes attributable to deemed military service wage credits for 1983, the bill delays the final adjustment of the estimated amount transferred to the trust funds based on deemed military service wage credits for 1983 by providing that the yearly authorizations of appropriations to the Social Security trust funds from the general fund may include adjustments of prior estimates for wages deemed to have been paid in 1983.

8. Effective date for elimination of gender-based distinction concerning entitlement of divorced husbands (sec. 642(d) of the bill and sec. 202(c) of the Act)

Present Law

The Social Security Amendments of 1983 provided that divorced spouses could become entitled to benefits without regard to the entitlement of their former spouses. Due to a drafting error, the provision applies to divorced husbands who become entitled to benefits after April 1983 and divorced wives who become entitled after December 1984.

Explanation of Provision

The bill corrects this discrepancy and eliminates this newly created gender-based distinction since P.L. 98-21 sought to eliminate all gender-based distinctions in the Act.

9. Effective date for treatment of certain deferred remuneration (sec. 642(g)(2) of the bill, secs. 3121 and 3306 of the Code, and sec. 209 of the Act).

Present Law

Under the Social Security Amendments of 1983, remuneration paid after services are performed, other than amounts paid under a qualified retirement plan, generally is taxable when paid, for FICA and FUTA purposes. Amounts deferred under nonqualified deferred compensation plans, however, are included in an employee's FICA and FUTA base when the services for which the amounts are payable are performed or, if later, when there is a lapse of a substantial risk of forfeiture of the employee's right to those amounts.

In general, the provision relating to certain deferred remuneration is effective for remuneration paid after December 31, 1983 (for FICA and social security benefit purposes), and after December 31, 1984 (for FUTA purposes). Under a grandfather rule, in the case of any agreement, in existence on March 24, 1983, between a nonqualified deferred compensation plan and an individual, the provision applies only with respect to remuneration paid that is attributable to services performed after December 31, 1983 (December 31, 1984, for FUTA purposes). As drafted, the treatment for FICA and social security benefit purposes is not clear, for example, for deferred compensation under an agreement not in existence on March 24, 1983, for services performed in 1983 and for which there is no substantial risk of forfeiture at some point during 1983. Further, the grandfather rule does not apply to payments under retirement or termination agreements, other than deferred compensation agreements, which may be qualified for exemption from FICA and FUTA under prior law.

Explanation of Provision

The bill makes two changes in the effective date of the above provisions of the 1983 Amendments. First, in order to eliminate the ambiguity in the tax treatment of nonqualified deferred compensation not subject to the grandfather rule, the bill provides that remuneration, which is paid after December 31, 1983 (December 31, 1984 for FUTA purposes) but would have been included in the definition of wages on or before that date if the provisions of the Social Security Amendments of 1983 had applied on or before that date, is included in the definition of wages when the remuneration is paid, or, at the election of the payor, at the time which would be appropriate if such amendments had applied. Thus, for example, if an individual enters into a nonqualified deferred compensation arrangement after March 24, 1983, and before January 1, 1984, the bill provides that with respect to services performed before January 1, 1984 deferred amounts for which risk of forfeiture lapses during 1983 are included in wages for FICA tax purposes when the amounts are paid after December 31, 1983, unless the payor elects to treat them as wages paid during 1983. Of course, the grandfather rule for certain agreements in existence on March 24, 1983, still applies to insure that remuneration attributable to services performed before January 1, 1984, and paid under these agreements continues to be subject to prior law.

Second, the bill extends the grandfather rule to apply to agreements in existence on March 24, 1983 between an individual and a plan or employer, if the agreement provided for making payments upon retirement which would have been excluded from tax under prior law. Thus, under the bill, if such an agreement was in existence on that date, prior law is applicable with respect to remuneration attributable to services performed before January 1, 1984, for FICA purposes (before January 1, 1985, for FUTA purposes).

10. Codification of Rowan decision (sec. 642(h) of the bill, secs. 3121 and 3306 of the Code, and sec. 209 of the Act)

Present Law

The Social Security Amendments of 1983 provided that, with the exception of the value of certain meals and lodging provided for the convenience of the employer, the determination of whether or not amounts are includible in the social security and FUTA wage bases is to be made without regard to whether such amounts are treated in regulations as wages for income tax withholding purposes. This provision thus prevents the application to compensation, other than meals and lodging, of the Supreme Court's reasoning in *Rowan Companies, Inc. vs. United States*, 452 U.S. 247 (1981). In this case, the Supreme Court held that, because the treatment of certain employer meals and lodging, excluded from gross income under section 119, for income tax withholding and for FICA purposes was not explicitly dealt with in the statutes governing these provisions, Treasury regulations defining wages for purposes of these two provisions had to be consistent. Thus, because one Treasury regulation excluded from wages for income tax withholding purposes the value of meals and lodging excluded from gross income under section 119, another regulation including these amounts in wages for FICA purposes was held to be invalid.

The provision in the Amendments applies to remuneration paid after December 31, 1983, for FICA and social security benefit purposes and to remuneration paid after December 31, 1984, for FUTA purposes. Thus, it is possible that this provision could be cited as demonstrating Congressional intent that the reasoning of the *Rowan* decision should generally apply before these dates to types of remuneration other than meals and lodging excluded under section 119, e.g., to contributions under a salary reduction agreement to tax-sheltered annuities (sec. 403(b)). These contributions have been held by the Treasury Department to be taxable for FICA purposes (Revenue Ruling 65-208) even though they are exempt by regulation from income tax withholding.[5] If the 1965 revenue ruling were determined to be invalid, then employers and employees would be eligible for refunds for open years because taxable wages would be lower. In addition, wages for benefit computation purposes would be reduced, leading in some cases to reduction of social security benefits being paid to current beneficiaries and recoupment of a portion of benefits which have been paid in recent years on the basis of wage records which included the salary reduction contributions.

Explanation of Provision

In order to avoid the inferences which this provision could raise, the bill clarifies the effective date of the provision overriding the *Rowan* decision so that the provision applies for all purposes, other than the treatment of certain employer-provided meals and lodging, both to remuneration paid after March 4, 1983, and to remuneration paid on or before March 4, 1983, which the employer treated as wages when paid. For example, if an employer treated as wages, for FICA or FUTA taxes (or both), the amounts contributed during 1982 to an employee's tax-sheltered annuity pursuant to a salary reduction agreement, the FICA or FUTA taxes (as the case may be) paid by the employer and employee may not be refunded or credited. The committee intends no inference as to the treatment of amounts paid on or before March 4, 1983, which the employer did not treat as wages when paid.

11. Exclusion from coverage of foreign agricultural workers under the Agricultural Act of 1949 (secs. 643(a)(7)(A) and 643(i)(3) of the bill and sec. 210(a)(1) of the Act and sec. 3121(b)(1) of the Code)

Present Law

Under present law, service performed by foreign agricultural workers under contracts entered into in accordance with title V of the Agricultural Act of 1949, as amended are excluded from coverage under the Social Security Act and taxation under the Internal Revenue Code.

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[5] The Social Security Amendments provide explicitly that contributions to tax-sheltered annuities under a salary reduction agreement are included in the wage base for social security and FUTA purposes, effective for remuneration paid after December 31, 1983 (December 31, 1984, for FUTA).

Explanation of Provision

In light of the fact that the provision of the Agricultural Act which provides for such contracts expired on December 31, 1964, the bill strikes the references in the law to the Agricultural Act of 1949, as amended.

12. Gender-based distinction concerning the penalty for fraud (sec. 643(e)(2) of the bill and sec. 1107(b) of the Act)

Present Law

Under present law, any person who, with the intent of eliciting information about the birth, employment, wages or benefits of any individual, falsely represents that he is either that individual or the husband, wife, widow, widower, divorced wife, child or parent of that individual is subject to the penalty for fraud set out in the law. However, a person who falsely represents himself as a divorced husband is not subject to the penalty.

Explanation of Provision

While the Social Security Amendments of 1983 sought to eliminate all gender-based distinctions in the Social Security Act, this gender-based distinction was not eliminated by those amendments. In order to assure that the Social Security Act provides the same penalty for fraud regardless of sex, the bill provides that the penalty for fraud would also apply to an individual who falsely represents that he is the divorced husband of a worker or beneficiary.

13. Treatment of social security benefits in computing credit for the elderly and disabled (sec. 643(i)(1) of the bill and sec. 86(f) of the Code)

Present Law

The credit for the elderly and permanently and totally disabled is equal to 15 percent of a base amount, which is reduced by amounts received of certain types of income (sec. 37). One such type of income is amounts received as a pension or annuity or disability benefit which is paid under title II of the Social Security Act and excluded from gross income. The section of the Social Security Amendments of 1983 dealing with the taxation of Social Security benefits contains a provision stating that social security benefits are to be treated as a pension or annuity for the purposes of certain Code sections, not including the credit for the elderly and disabled (sec. 86(f)).

Explanation of Provision

In order to remove any ambiguity as to the treatment of social security benefits in computing the credit for the elderly and disabled, the bill adds this credit to the list of provisions for which social security benefits are to be treated as an amount received as a pension or annuity.

14. Peer review organizations (sec. 646(a) of the bill and sec. 1866 of the Act)

Present Law

The Social Security Amendments of 1983 required hospitals to enter into an agreement with a Utilization and Quality Control Peer Review Organization (also known as a Peer Review Organization or PRO) as a condition of payment under the medicare program. The costs of such review are reimbursed through the medicare trust fund. A full transition from the Professional Standards Review Organization (PSRO) program to the PRO program has not yet been made.

Explanation of Provision

The bill treats PSRO's in a manner similar to that applied to PRO's under the Social Security Amendments while the transition is being made from PSRO's to PRO's. Hospitals would be required to enter into an agreement with a PSRO (which was in existence on July 1, 1983) before January 1, 1984 as a condition of medicare payment. The costs of the review will be paid from the medicare trust fund.

15. Medicare prospective payment (sec. 646(b) of the bill and secs. 1866, 1878 and 1886 of the Act)

Present Law

The Social Security Amendments of 1983 established a new system of paying hospitals under medicare, known as the prospective payment system.

Explanation of Provision

The bill clarifies that the percentage of payment to be made under target reimbursement as opposed to diagnosis related group payments (i.e., the phase-in of the DRG payment system from a cost-based system) is based on a hospital's cost reporting period, and that the 'applicable combined adjusted DRG prospective payment rates' are based on discharges occurring on or after October 1 of each year.

It was the intent of the legislation when passed that the DRG payment levels would change once a year, on October 1, with the Federal fiscal year. The blend of the regional and national payments into the DRG payment levels is a part of this calculation, and it was intended to be done once a year, beginning with the Federal fiscal year. This will mean that some hospitals, which have an accounting year beginning on a date other than October 1, will have less than a full hospital accounting year of a fully regional DRG payment.

To do otherwise would require that each medicare intermedicary keep a separate set of DRG payment levels for each hospital in an area depending on each hospital's accounting year. This would place a enormous administrative burden on the medicare program. Further, hospitals in the same area would have a different DRG payment level for the same service depending on the date on which the hospital's accounting year began.

The bill requires that State hospital cost control systems must prevent gaming and 'unbundling' of services and inappropriate admissions practices in order to be provided a medicare waiver.

The bill clarifies that public comment is required only on proposed determinations issued with respect to annual indexing of DRG's on June 1 of each year, beginning with fiscal year 1986.

The bill also requires that hospitals exempt from the DRG payment system have agreements with PRO's or PSRO's; it amends section 1878 of the Social Security Act to provide for consolidated judicial review of Provider Reimbursement Review Board (PRRB) determination of group petitions effective April 20, 1983; and it corrects a reference error in section 1818(c) of the Act.

16. Normalizing credit of medicare taxes to the Hospital Insurance Trust Fund (sec. 646(c) of the bill and sec. 1817 of the Act)

Present Law

The Social Security Amendments of 1983 revised the accounting procedures of the Old Age and Survivors, Disability, and Hospital Insurance Trust Funds to provide that the Treasury would credit to the trust funds, at the beginning of each month, the amount of payroll taxes estimated to be received during the month. Under prior law, amounts were paid to the trust fund from "time to time."

Explanation of Provision

The bill repeals the "normalization" provisions with respect to the Hospital Insurance Trust Fund. Thus, funds will be transferred from the Treasury to the HI Trust Fund as under prior law. The provision does not affect the OASDI Trust Funds.

17. Effective dates relating to certain medicare changes (sec. 646(d) of the bill and secs. 1878 and 1886 of the Act)

Present Law

The Social Security Amendments of 1983 made certain changes with respect to group appeals under the Provider Reimbursement Review Board. In addition, the Amendments required the Secretary of Health and Human Services to issue regulations with respect to prospective payment by a certain date.

Explanation of Provision

The bill clarifies that the PRRB changes only apply to appeals and actions brought after April 20, 1983. It also clarifies that the regulations for implementing all the medicare-related amendments (not merely those directly related to DRG payments) are to be made on an interim-final basis.

18. Enrollment and premium penalty with respect to working aged provision (sec. 647 of the bill and sec. 1839 of the Act)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 requires employers to offer to their employees age 65 through 69 the same group health plan which is offered to their employees under 65. Where the employee chooses the employer plan, medicare becomes the secondary payor.

Under present law, a penalty equal to 10 percent of the part B premium is assessed against an individual for every year in which he or she fails to enroll in medicare part B after he or she becomes eligible for benefits. Further, an individual who does not enroll when initially eligible at 65, may enroll in medicare only during the January through March enrollment period.

Explanation of Provision

The bill eliminates any penalty for late enrollment in medicare for any individual 65 through 69 for any month in which the individual can demonstrate that he or she was enrolled as an employee (or a spouse of an employee) in an employer group health plan which is a primary payor to the medicare program.

The provision is intended to apply with respect to months in which the individual was an employee and enrolled in a plan. Thus, an individual who was employed after age 65, became unemployed and was subsequently reemployed could count those periods during which he or she was employed and covered by a plan regardless of the intervening unemployment. The use of the phrase—by reason of current employment—was meant to distinguish those persons who are receiving health benefits based on employment and are actually employed from those persons who are receiving benefits based on employment, but who are now retired.

A special enrollment period will be provided to individuals age 65 through 69 who did not elect coverage under medicare during their initial enrollment period because of coverage at the time under an employer plan and who lose such employer coverage or turn 70 years of age. In addition, there is also a special enrollment period for those who were enrolled during periods in which they were not covered under an employer plan, who have not terminated medicare enrollment other than at a time when they were covered under such a group health plan or turn 70. These special enrollment periods begin either three months before the month in which the individual turns 70 and last seven months, or begin with the month in which the individual loses coverage under the employer plan and last seven months, whichever begins earlier. Where the individual has such a special enrollment period, because the individual turns 70 or the employer coverage terminates, medicare coverage begins in a manner similar to current law for individuals turning 65. If the individual enrolls in the month in which he or she turns 70, the coverage period begins with the first day of the following month.

The regulations issued by the Equal Employment Opportunity Commission pursuant to the original 'working aged' provision made it clear that employees were to be fully informed of their options at the time of selecting either the employer plan or medicare. One of the points which should be made clear to the beneficiary at the time he or she is informed of the options is the impact on the premium and on enrollment periods of certain decisions with respect to the employer plan and medicare.

19. Clerical amendments

The bill will make certain corrections of spelling, punctuation, cross-references and other clerical amendments to the Social Security Act and related provisions in the Internal Revenue Code.

F. Effective Dates

Except as otherwise described, the amendments made by the Technical Corrections Act of 1983 will take effect as if included in the original legislation to which each amendment relates.

G. Revenue Effect

The provisions contained in the Technical Corrections Act of 1983 have a negligible revenue effect.

TITLE VII—TAX EXEMPT BOND PROVISIONS

A. Mortgage Subsidy Bonds

Present Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act")[1] imposed restrictions on the ability of State or local governments to issue bonds, the interest on which is tax-exempt, for the purpose of making mortgage loans on single-family, owner-occupied residences. The 1980 Act provides that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified veterans' mortgage bonds" or "qualified mortgage bonds".

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Unlike qualified mortgage bonds, the tax-exemption for veterans' bonds does not expire on December 31, 1983, and they are not subject to the volume, arbitrage, and most of the targeting rules applicable to qualified mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds must satisfy numerous requirements, discussed below. Also, interest on these bonds is tax-exempt only if the bonds are issued before January 1, 1984.

Volume limitations

The 1980 Act restricts the aggregate annual volume of qualified mortgage bonds that a State, and local governments within the State, can issue. The State ceiling is equal to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the 3 preceding years for single-family, owner-occupied residences located within the States, or (2) $200 million. The State ceiling is generally allocated 50 percent to State and 50 percent to local issuers (on the basis of mortgage activity), unless the state provides a different allocation formula.

Limitation to single-family, owner-occupied residences

All lendable proceeds (i.e., total proceeds less issuance costs and reasonable required reserves) of qualified mortgage bonds must be used to finance the purchase of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must be reasonably expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. Generally, the term single-family residence includes 2-, 3-, and 4-family residences if (1) the units in the residence were first occupied at least 5 years before the mortgage is executed and (2) one unit in the residence is occupied by the owner of the units.

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[1] Title XI of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The provisions adopted by the 1980 Act (Code sec. 193A) were subsequently amended by section 220 of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA).

General limitation to new mortgages

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new mortgages rather than existing mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Rehabilitation loans must be made for work begun at least 20 years after the residence is first used and the expenditures must equal 25 percent or more of the mortgagor's adjusted basis in the building. Additionaly, at least 75 percent of the existing external walls of the building must be retained as such after the rehabilitation.

Certain mortgage assumptions permitted

Loans financed by qualified mortgage bond proceeds may be assumed if the residence satisfied the location and principal residence requirements, discussed above, and the assuming mortgagor satisfies the 3-year and purchase price requirements, discussed below.

Limitation on advance refunding

Qualified mortgage bonds may not be advance refunded.

Targeting requirement

At least 20 percent of the lendable proceeds of each issue of qualified mortgage bonds (but not more than 40 percent of the average mortgage activity in the targeted area) must be made available for owner-financing in targeted areas for a period of at least one year. The term "targeted areas" for a period of at least one year. The term "targeted area" means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income, or an area designated as an area of chronic economic distress.

Three-year requirement

In order for an issue to be a qualified morgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who had no present ownership interest in a principal residence at any time during the 3-year period ending on the date the morgage is granted.[2] The 3-year requirement does not apply with respect to mortgagors of residences in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans; (3) mortgagors who receive qualified rehabilitation loan.[3]

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[2] TEFRA reduced the percentage of bond proceeds that must be used in a manner satisfying the 3-year requirement from 100 percent to 90 percent, effective for bonds issued after September 3, 1982.

Purchase price restrictions

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, are required to be for the purchase of residences the acquisition cost of which does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to that residence.[4]

Arbitrage requirements

In order for an issue to be a qualified mortgage issue, the issue is required to meet certain limitations regarding arbitrage as to both mortgage loans and nonmortgage investments.

Mortgage investments.—The effective rate of interest on mortgages provided under an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.[5] This determination is made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than 1.125 percentage points above the yield of the issue if other mortgages have a lower effective interest rate.

Nonmortgage investments.—The 1980 Act also imposed restrictions on the arbitrage permitted to be earned on nonmorgage investments. The amount of qualified mortgage bond proceeds that can be invested at unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for an initial temporary period until such proceeds are needed for mortgages and for temporary debt service funds. Arbitrage earned by the issuer or an intermediary on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Qualified mortgage bonds usually have established a reserve to secure payment of the debt service on the bonds. This reserve must be reduced as debt service is reduced. However, if the sale of any investment would result in a loss exceeding the amount otherwise required to be paid or credited to mortgagors, the investment may be retained until it can be sold without resulting in such a loss.[6]

Limited equity cooperatives

Present law provides that the owner of shares in housing cooperatives are to be treated as homeowners for purposes of the Code by allowing a deduction for the portion of the rents paid to the cooperative that are allocable to the interest and taxes paid by the cooperative on the property (sec. 216). The Tax Equity and Fiscal Responsibility Act of 1983, (P.L. 97-248) (TEFRA) included changes in the mortgage subsidy bond provisions to enable tenant shareholders of cooperatives to be eligible for tax-exempt financing as single family residences.

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[3] Qualified home improvement loans are loans, not exceeding $15,000, that finance the alteration or repair of a residence in a manner that substantially protects "the basic livability or energy efficiency of the property" (sec. 103A(1)(6)).

[4] TEFRA increased the maximum purchase price restriction from 90 percent (110 percent in targeted areas) to its present level, effective for bonds issued after September 3, 1982.

[5] TEFRA increased the maximum permitted arbitrage from 1 percentage point to 1.125 percentage points, effective for bonds issued after September 3, 1982.

[6] The rule permitting retention of an investment where its disposition would result in a loss was added by TEFRA, effective for bonds issued after September 3, 1982.

Reasons for Change

The committee believes that mortgage subsidy bonds can perform a valuable function by enabling first-time homebuyers who might otherwise be unable to purchase a home, because of high interest rates, to do so. When Congress, in 1982, decided to relax certain of the restrictions on mortgage subsidy bonds, the interest rate on taxable mortgages approached 15 percent and the housing market was in a state of extreme crisis. Since that time, there has been a significant improvement in the housing market; however, the average mortgage interest rate is approximately 12.5 percent, and it remains difficult for the average American (particularly first-time homebuyers) to purchase a single-family residence. In this situation, the committee believes that the mortgage bond program can continue to make an important contribution by making housing more affordable to low- and middle-income Americans. Accordingly, the committee decided that the qualified mortgage bond program should be extended.

In order to provide an opportunity for reassessment of the mortgage bond program under changing conditions, the committee decided that the program should be extended for a 5-year period only (i.e., for bonds issued prior to January 1, 1989). In the interim, in order to ensure an adequate basis for reevaluation, mortgage subsidy bonds will be subject to rules similar to the information reporting requirements for private purpose tax-exempt bonds.

While approving the extension of the qualified mortgage bond program, the committee is aware of the relative inefficiency of tax-exempt bonds as a means of providing a subsidy to first-time homebuyers. Additionally, the committee is aware that, because of the nature of tax-exempt financing, it may be difficult to target the subsidy provided by mortgage bonds to those most in need of housing assistance. The committee therefore decided to offer States and localities the alternative of distributing mortgage credit certificates (MCCs) in place of mortgage subsidy bonds. The rules for distributing MCC have been designed so as to provide assistance to the same beneficiaries eligible for qualified mortgage bonds at a subsidy level that is the same or a slightly increased as that provided by mortgage subsidy bonds. However, under the MCC program, the entire amount of subsidy flows directly to the first-time homebuyer, rather than part of the subsidy flowing to the first-tme homebuyer and part to the tax-exempt investor and middlemen as under a bond program. Thus, the committee believes that MCCs will provide a larger subsidy at an equivalent, or reduced, revenue cost. Additionally, by varying the amount of individual credits, State and local issuing authorities may achieve greater flexibility in targeting the subsidy to those individuals who are considered most in need.

The committee intends that States and localities have the choice of issuing qualified mortgage bonds or MCCs, or a mix of bonds and credits, according to their particular needs. However, because of the relative ease of issuing credits (as opposed to issuing qualified mortgage bonds), the committee believes that a transitional rule is necessary to provide equity between States and to minimize the potential revenue loss associated with MCCs. The committee therefore decided to impose a 5-year phase-in of authority to issue MCCs for States which issued less than their statutory maximum of qualified mortgage bonds in 1983. Also to mimimize the potential revenue loss, the committee decided that the minimum $200 million State ceiling for qualified mortgage bonds should not apply in determining the amount of MCCs which may be issued within a State. This rule is necessary to prevent States or localities from exchanging bond authority which may now be unusable for authority to issue mortgage credits. In order to provide an opportunity to review the MCC program, the committee provided that MCCs would sunset on December 31, 1986.

In deciding to extend the mortgage bond program, the committee was concerned by the increasing volume of veterans' mortgage bonds being issued by a number of States (approximately $2.9 billion in the years 1980 through 1982) and the potential for expansion of qualified veterans' mortgage bonds in States that do not issue those bonds. To limit the potential revenue loss from veterans' bonds, the committee decided that the amount of qualified mortgage bond authority for a State in any year should be reduced by the volume of qualified veterans' mortgage bonds issued in the prior year. Additionally, the committee's bill subjects qualified veterans' mortgage bonds to the sunset applicable to qualified mortgage bonds. This inclusion will also provide greater equity between States which emphasize a veterans' bond program and those which rely primarily on qualified mortgage bonds or credits.

The Committee understands that housing cooperatives may have difficulties complying with the requirements for mortgage subsidy bond financing, in particular the first time home buyer limitation. The Committee believes that certain limited equity housing cooperatives have the same essential characteristics as multifamily residential rental projects and should therefore be eligible for tax-exempt financing under the industrial development bond provisions applicable to such projects. However, the Committee believes that, where cooperatives are treated as multifamily residential rental property under the IDB provisions, such treatment should be consistent for all purposes of the Code. Consequently, the committee bill provides that tenant stockholders of limited equity cooperative housing corporations which use tax-exempt IDB financing as multifamily residential rental projects are not eligible for the deductions available to home owners of single family residences.

Explanation of Provision

1. Extension of authority to issue qualified mortgage bonds qualified mortgage bonds

The bill extends the tax exemption for interest on qualified mortgage bonds to bonds issued prior to January 1, 1989.

Qualified veterans' mortgage bonds

Under the bill, the tax exemption for interest on qualified veterans' mortgage bonds is limited to bonds issued prior to January 1, 1989. Additionally, the State ceiling for qualified mortgage bonds is to be reduced by the aggregate amount of qualified veterans' mortgage bonds issued in the State during the preceding calendar year. For purposes of this reduction, a specified amount of qualified veterans' mortgage bonds the issuance of which was authorized by a State referendum before October 18, 1983, or the issuance of which was authorized pursuant to a State referendum before December 31, 1983, which referendum was authorized by action of a State legislature before October 18, 1983, are not to be taken into account. Except for these exceptions, the reduction in the ceiling for qualified mortgage bonds on account of qualified veterans' mortgage bonds issued in a prior year would begin in 1985 with respect to bonds issued in 1984.

Information reporting requirements

The bill requires that any issuer of mortgage subsidy bonds (including qualified mortgage bonds and qualified veterans' mortgage bonds) must submit to the Treasury Department, by the fifteenth day of the second calendar month after the close of the calendar quarter in which the bonds were issued, a statement providing certain information concerning the issue. This statement must contain (1) the name and address of the issuer, (2) the date of the issue, the amount of lendable proceeds at the issue, and the rate, term and face amount of each obligation which is part of the issue, and (3) such other information as the Treasury may require (including information required in order to determine whether the issue qualified for tax exemption). The bill allows the Treasury to provide for extensions of time for providing any information where there is reasonable cause for delay.

Extension of State allocation formula

The bill provides that, if a State law which provides a formula for allocation of the State's qualified mortgage bond ceiling among State and local issuers expires as of the close of calendar year 1983, the law shall be treated as remaining in effect after 1983. If the expiring formula requires action by a State official in order to allocate the State ceiling, actions of such officials shall continue to be effective. The extension of the previous formula shall be effective until the effective date of any new State legislation with respect to allocation of the ceiling.

2. Mortgage credits certificates

In general

The bill allows State and local governments to elect, for any calendar year beginning after 1983, to exchange all or part of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle taxpayers to nonrefundable Federal income tax credits for not more than 50 percent (but not less than 10 percent) of interest on indebtedness incurred to finance the acquisition (or qualified rehabilitation or improvement) of qualified principal residences. The credits are subject to the existing eligibility requirements for qualified mortgage bonds. For States and localities which issued less than their statutory maximum of qualified mortgage bonds during calendar year 1983, authority to issue MCCs would be phased in over a 5-year period.

Qualified mortgage credit certificates (MCCs)

Mortgage credit certificates (MCCs) are to take the form of certificates issued to qualifying homebuyers. Each certificate is to specify (1) the principal amount of indebtedness which qualified for the credit and (2) the applicable percentage rate of the credit. The applicable percentage may not exceed 50 percent (25 percent in the case of mortgage assumptions), but cannot be less than 10 percent, of interest on the qualifying indebtedness. (The actual amount of the credit in any year depends upon the mortgage interest paid during the taxable year.) The certificate entitles the taxpayer to a credit against his Federal income taxes based on mortgage interest paid during any taxable year during which the taxpayer uses the residence as his principal residence.

MCCs are not refundable to the taxpayer (i.e., credit amounts in excess of any Federal income taxes would not be refunded to the taxpayer). However, excess credits can be carried over to reduce tax liability of the taxpayer arising in any subsequent year. When a taxpayer received a MCC, the taxpayer's deduction for interest on the qualifying mortgage (sec. 163(a)) is reduced by the amount of the credit. For example, a taxpayer receiving a 50-percent credit, and making $5,000 of interest payments in a given year, is to receive a $2,500 credit and a deduction for the remaining $2,500 of interest payments.

Under the bill, MCCs are not be available for residences financed with mortgage subsidy bonds. Additionally, loans between related parties would not qualify for the credit. Finally, MCCs are not available if the homebuyer is required to obtain his mortgage from specified mortgagees.

Criteria for eligibility

MCCs generally are subject to the existing eligibility requirements applicable to qualified mortgage bonds. Thus, MCCs are generally (1) limited to single-family owner occupied residences (as defined under the qualified mortgage bond provisions) located within the jurisdiction of the issuing authority, (2) available only for new mortgages (with allowances for qualified rehabilitation and improvement loans and for certain mortgage assumptions), and (3) available to finance the acquisition of residences the acquisition cost of which does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to the residence. Additionally, 90 percent of MCCs must be distributed under each MCC program only to mortgagors who did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is granted (with exceptions for qualified rehabilitation and home improvement loans and residences located in targeted areas). However, unless an issuing authority submits a plan to Treasury Secretary for administering the 90 percent requirement and the Treasury Secretary is satisfied that such requirement will be met under the plan, all of the MCCs must be distributed to individuals which meet the 3-year requirement. Finally, at least 20 percent of the aggregate amount of MCCs issued under each program are required to be made available for financing in targeted areas for a period of at least one year. Where MCCs are issued to finance a particular development, the developer is required to certify that the price for any residence is not higher than it would be without the use of the credits.

Under the bill, MCCs may be issued for debt incurred to refinance a principal residence with respect to which a MCC had previously been issued if the refinancing takes the place of an existing mortgage for which a certificate has already been issued and does not extend the term or increase the principal amount of the original mortgage.

As in the case of qualified mortgage bonds, a State or locality may establish more stringent criteria for participation in an MCC program, including the ability to prevent assumptions of the credits.

Volume limitations

General limits.—Under the bill, the aggregate annual amount of MCCs distributable by a State or locality may not exceed 15 percent of the volume of qualified mortgage bond authority exchanged by the State or locality. For example, a State which is entitled to issue $200 million of qualified mortgage bonds, and which elects to surrender $100 million of bond authority, may distribute an aggregate amount of MCCs not exceeding $15 million.

The aggregate annual amount of MCCs issued by a State or locality is to be determined by multiplying (1) the principal amount of each MCC certificate issued by the State or locality by (2) the applicable percentage for each certificate, and adding the products. For example, a State with $15 million of MCC authority may distribute credits for 15 percent of the interest payments on mortgages having an aggregate principal amount of $100 million (thereby approximating the benefits provided by $100 million of mortgage subsidy bonds). However, the State may also issue any other mix of higher or lower percentage credits in an aggregate amount not exceeding $15 million (subject to the 10- and 15-percent requirements and the targeting and purchase price requirements applicable to mortgage subsidy bonds). For example, a State may determine to issue higher percentage credits to lower-income individuals.

Where a State MCC program issued credits exceeding 15 percent of the amount of exchanged bond authority, the State's ceiling for the subsequent year would be reduced by twice the excess.[7] Similarly, where a State MCC program failed to satisfy the proper eligibility requirements, the State's ceiling for the subsequent year would be reduced by twice the amount of ineligible indebtedness.

Phase-in of and limitations on MCC authority.—States or localities which issued qualified mortgage bonds in amounts less than their maximum legal authority during calendar year 1983 are subject to a 5-year phase-in of authority to issue MCCs. For each of these years, the amount of qualified mortgage bond authority which a State or locality may exchange for authority to issue MCCs is limited to the volume of qualified mortgage bonds it actually issued in 1983, increased for each year by 25 percent of the remaining difference between the 1983 volume and the statutory amount. However, in no event could the volume of bond authority exchanged for MCCs exceed 9 percent of the average volume of mortgages on single family residences originated with the State in the prior three years. Where a State or locality issues both qualified mortgage bonds and MCCs, the phase-in will apply to the total amount of bonds and credits which it could issue. The phase-in does not apply if the State elects to issue only mortgage bonds.

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[7] It is expected that Treasury regulations will establish a procedure permitting the issuer (or other State or local agencies) to make binding certifications to the effect that an issue has not exceeded the issuer's volume limitation for the year of the issue. The regulations may provide Treasury with authority to suspend or withdraw such certifications if the certifications made by an issuer with respect to past issues are incorrect.

Public notification requirement

Under the bill, State or local housing agencies may issue MCCs only after making generally available, at least 90 days prior to distribution, a proposed plan of distribution of the credits. The proposed plan must set forth the eligibility requirements to receive MCC certificates and the methods by which the certificate would be issued. State or local agencies may adopt plans of distribution for MCCs in connection with other housing assistance program (including taxable bond issues, private development projects, or private mortgage lending programs).

Administration of MCC program

The mortgage credit certificate program is to be administered as provided by Treasury regulations. It is anticipated that these regulations will provide that a local issuer desiring to issue mortgage credits would file an election with the housing authority (or agency designated by the Governor) for the State in which the issuer is located. The State housing authority would determine whether the issuer has sufficient qualified mortgage bond authority to cover the election and, if it does, the State housing authority would approve the election and notify the Internal Revenue Service of the election. The local issuer or State issuer would distribute MCCs to applicants who represent to the issuer in signed statement that they meet the eligibility requirememts pertaining to MCCs. The credit certificate would set forth relevant information such as the following: name of local issuer, the date of the local issuer's election to issue mortgage credit certificates, the name and social security number of the applicant, the percentage rate of credit, the maximum amount of the loan (if the State decides to impose a limit), and other relevant information required by the Treasury.

It is anticipated that the homebuyer to whom credit certificates have been awarded would take the credit certificate to a lending institution. The lending institution would determine whether the applicant meets the first-time homebuyer requirement (by examining the applicant's tax returns) and the purchase price limit. The lending institution would sign a statement on the credit certificate, under penalties of perjury, that it has made the foregoing determinations and examined the applicant's tax returns. The institution also would state on the credit certificate the principal amount of the mortgage, the purchase price of the house, and the address of the property. The lending institution would send copies of the credit certificate to the homebuyer, the local issuer, and the State housing authority. The lending institution also would file reports with the IRS which would permit the IRS to audit individual tax returns and to audit States to determine whether volume limits and other statutory requirements were satisfied. A penalty of $200 is imposed by the bill on a mortgage originator (i.e., lending institution) for failure to file the required information with respect to any homebuyer that received a certificate. Similar requirements would be imposed on mortgage originators and their transferees with respect to homebuyers who assume a seller's mortgage together with a mortgage credit certificate.

It is anticipated that the Treasury regulations will require State housing authorities to file a report with the IRS for each calendar year showing the issuers qualified mortgage bond allocation, the dates and amounts of election to issue MCCs, and the total amount of credits issued pursuant to each election. The State housing authority would also be required to report if a credit certificate was revoked.

3. Limited equity cooperatives

The bill provides that limited equity housing cooperatives are eligible, at the election of the cooperative, for tax-exempt financing as multifamily residential rental housing (under sec. 103(b)(4)(A)). Limited equity housing cooperatives are cooperative housing corporations (as defined under sec. 216(b)(1)) in which a person is entitled to occupy a dwelling unit by reason of ownership of stock in the cooperative. Additionally, to qualify for financing as multifamily residential rental property, (1) the cost of any stock in the cooperative must not exceed the amount paid for the stock by the original stockholder (as adjusted for cost-of-living increase), increased by amounts paid for improvements on the stockholder's house or apartment and certain other payments and contributions attributable to the stockholder, and (2) the assets of the cooperative in excess of the combined transfer values of outstanding stock in the cooperative (reduced by any liabilities) must be used only for public or charitable purposes or directly to benefit the cooperative and must not be used directly to benefit any stockholder.

The bill provides that, where a limited equity housing cooperative elects to be eligible for financing as multifamily residential rental property, the cooperative's tenant shareholders will not be entitled to a deduction for their ratable share of interest and taxes paid by the cooperative (sec. 216). Additionally, bonds issued to finance units in the cooperative will be counted toward the State's volume cap for mortgage subsidy bonds, except to the extent that the financing had previously been counted towards the volume cap for private activity bonds. The election to be eligible for financing as multifamiliy residential rental property is to be irrevocable and is to apply only if the cooperative continues to qualify as a limited equity cooperative.

If an election as described above is not made, a limited equity housing coopertive is eligible for qualified mortgage bond financing (as under present law). Such financing will subject to all the limitations applicable to qualified mortgage bonds (including the first-time purchaser, purchase price, and statewide volume limitations).

Effective Date

The extension of the mortgage subsidy bond program is effective on the date of enactment. The election for States and localities to issue mortgage credits is effective for interest paid or accrued after December 31, 1983, on mortgages executed after December 31, 1983, with respect to elections to trade in authority of States and localities for calendar years after 1983. The election of certain limited equity housing cooperatives to be treated as multi family residential rental projects is effective for obligations issued after December 31, 1983.

Revenue Effect

The provisions regarding mortgage subsidy bonds and mortgage credit certificates are estimated to reduce fiscal year budget receipts by $48 million in 1984, $201 million in 1985, $418 million in 1986, $641 million in 1987 and $859 million in 1988.

B. Industrial Development Bonds

Present Law

General rules

Tax exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services (including schools, roads, water, sewer, and general improvement projects and the financing of public debt). Additionally, State and local governments may provide tax-exempt financing for certain private trades or businesses, student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations.

Industrial development bonds

Under present law, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of which are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. A nonexempt person is defined to mean all persons other than State or local governments or tax-exempt charitable, religious, educational, etc. organizations (described in Code sec. 501(c)(3)).

Exempt purpose IDBs

One of the exceptions under which interest on IDBs is tax exempt is where the proceeds of the IDBs are used for certain exempt functions. Under this rule, interest on IDBs is tax-exempt if the bonds are used to finance the following activities: (1) certain projects for low-income residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; or (10) local district heating or cooling facilities. In addition, interest on IDBs used to acquire or develop land as the site for an industrial park is exempt from tax.

Treasury Regulations provide that whether the proceeds of an obligation are used for exempt facilities is to be determined by the ultimate use of the proceeds. Treas. Reg. sec. 1.103-8(a)(4). The regulations illustrate this principle by indicating that bond proceeds are used for an exempt purpose where the proceeds of the bond are lent to banks or other financial institutions who then relend those proceeds for exempt functions (referred to as a "loan to lenders" program).

Small issue IDBs

In general.—Present law provides a tax exemption for small issue IDBs used for the acquisition, construction, or improvement of land or depreciable property.[8] The exemption applies to issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during the 6-year period beginning 3 years before the date of issue and ending 3 years after the date, must not exceed $10,000,000.[9]

In determining whether an issue meets the requirements above, prior small issues and (in the case of the $10,000,000 limitation) capital expenditures are taken into account if (1) they are used with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with small issue IDBs, and (2) the principal users of both facilities are the same or two or more related persons. "Related persons" include family members, fiduciaries, and corporations (or partnerships) subject to common control. Capital expenditures are not taken into account if (1) they are made to replace property destroyed or damaged by fire, storm, or other casualty, (2) are required by a change in Federal, State or local law (or the application of such laws) made after the date of issue, (3) are required by circumstances which could not reasonably be foreseen on the date of issue, or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

The Internal Revenue Service has generally ruled that, for purposes of the small issue volume limitations, where the facilities comprising a project are owned by unrelated parties, each party will be considered the principal user only of its own facility. Thus, under present law, a project in excess of $10,000,000 (e.g., a multistory office building) may be divided into several nominally separate facilities, each costing $10,000,000 or less, and each separate facility may be financed by corresponding separate small issues of IDBs.

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[8] The small issue exemption does not apply to obligations a significant portion of the proceeds of which are used to provide residential real property for family units.

[9] In the case of facilities with respect to which an Urban Development Action Grant ("UDAG grant") is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20,000,000 are allowed.

TEFRA limitations on small issue IDBs.—The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, imposed the following new restrictions on small issue IDBs. First, TEFRA provided that the small issue exemption will not apply to obligations issued after December 31, 1986. Second, TEFRA provided that the $1 million "clean limit" exemption is not available for any IDB issued as part of the same issue as other obligations, the interest on which is tax-exempt under a provision other than the small issue exemption. (The alternative $10,000,000 limitation remains available for combined issues.) Third, TEFRA eliminated the small issue exemption for bonds issued after December 31, 1982, if (1) more than 25 percent of the proceeds of the issue are used to provide a facility the primary purpose of which is retail food and beverage services (including all eating and drinking establishments but not grocery stores), automobile sales or services, or the provision of recreation or entertainment, or (2) any portion of which is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including any handball or racquetball court), hot tub or sun tan facility, or racetrack. The TEFRA use limitations do not affect bonds issued pursuant to exemptions other than the small issue exemption.

In addition to the above limitation, TEFRA provided that multiple lots of small issue IDBs will not be treated as on issue unless the proceeds are used to finance two or more facilities which (1) are located in more than one State or (2) have the same or related principal users.[10] Under this rule, multiple lots of IDBs may qualify as tax exempt as long as each separate issue qualifies as a small issue.

Scholarship funding bonds

In addition to State and local obligations, qualified scholarship funding bonds are exempt from Federal income tax. Qualified scholarship funding bonds are obligations issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loan notes. To qualify for tax exemption, the corporation must be required to use any income (after payment of expenses and debt service) to purchase additional student loan notes, or to pay over any income to the State or a political subdivision.

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[10] For purposes of this rule, "principal users" include persons (other than governmental units) which (1) arranges or assists in the issuance or guarantees (directly or indirectly) the repayment of any obligation used to finance the facility, and (2) provides any property, franchise, or trademark to be used in connection with the facility.

Cost recovery for property financed with tax-exempt bonds

Accelerated cost recovery (ACRS)

Present law provides for a reasonable depreciation allowance for property used in a taxpayer's trade or business or held for the production of income. Under the Economic Recovery Tax Act of 1981 (Pub. L. 97-34), cost recovery for tangible property placed in service on or after January 1, 1981, is determined according to the Accelerated Cost Recovery System (ACRS). ACRS provides for capital cost recovery over predetermined periods that are generally unrelated to, but shorter than, the useful lives of the property as determined under prior law.

Recovery of costs under ACRS is determined by using a statutorily accelerated method. The shedules were developed to approximate the benefits of using a 150-percent declining balance method for the early recovery years and the straight-line method for later recovery years. For 15-year real property, the schedules reflect a 175 percent declining balance method (200 percent for low-income real property) switching to the straight-line method.

As an alternative to ACRS, a taxpayer may elect to depreciate real or personal property on the straight-line method over ACRS or extended recovery periods.

Property financed with tax-exempt bonds

TEFRA provided that property placed in service on or after January 1, 1983, generally is not eligible for full ACRS deductions or other accelerated cost recovery deductions, to the extent that the property is financed with tax-exempt IDBs. In lieu of the full ACRS deductions reflecting the accelerated recovery rates, the cost of personal property financed with IDBs must be recovered using the straight-line method (with a half-year convention and without regard to salvage value) over the applicable ACRS period. For 15-year real property, costs are to be recovered using the straight-line method (with a monthly convention and without regard to salvage value) over a 15-year period.

TEFRA provided several exceptions under which IDB-Financed facilities may continue to be eligible for full ACRS deductions. The exceptions include: (1) Projects for low-income residential rental property; (2) public sewage or solid waste disposal facilities, where substantially all of the sewage or solid waste (other than recycled waste) processed by the facility is collected from the general public; (3) air or water pollution control facilities which are installed in connection with a facility in existence on July 1, 1982, or which are used in connection with conversion of oil- or gas-fired facilities to coal (but only if the oil- or gas-fired furnace which is converted to coal was in use at the facility before July 1, 1982); and (4) facilities with respect to which an Urban Development Action Grant ("UDAG grant") has been made..

The limitations on ACRS deductions, where applicable, apply to both the first owner of the property and to any subsequent owners who acquire the property while the tax-exempt IDBs (including any refunding issues) are outstanding.[11] the limitations do not apply if the taxpayer has elected a longer recovery period for the property than that provided by the limitations.

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[11] If tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for the property in prior years.

Arbitrage limitations

Present law denies a tax exemption to obligations (including IDBs or other State or local obligations) which are treated as arbitrage bonds. An arbitrage bond is defined as an obligation which is part of an issue all or a major part of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations which produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds which are so used). There are exceptions for materially higher yielding obligations held for a temporary period or in a reasonably required reserve or replacement fund.

Present law does not provide a statutory definition of what constitutes a "materially higher" yield. However, Treasury regulations provide rules for purposes of determining when an obligation acquired with the proceeds of tax exempt bonds has a yield materially higher than the bond yield. In general, a yield more than 0.125 percent above the bond yield is considered materially higher. In the case of certain obligations, such as student loans and loans to provide housing, the yield on the acquired obligations may exceed the bond yield by as much as 1.5 percent.

Federally guaranteed tax-exempt bonds

In general

The Public Debt Act of 1941 prohibits the Federal government from issuing tax-exempt obligations. Since that time, the Federal Government has generally refrained from guaranteeing tax-exempt State or municipal bonds. However, in the case of bonds the proceeds of which are deposited in federally insured financial institutions, federal deposit insurance may provide an effective guarantee for the bonds. In certain other cases, Federal agencies may provide additional security for tax-exempt bonds through (1) the guarantee of obligations which are used to secure tax-exempt bonds or (2) the subordination of debts owed to the Federal Government to the tax-exempt bonds. In other cases, regulations specifically prohibit the guarantee of tax-exempt obligations.

Tax-exempt IDBs guaranteed by FDIC or FSLIC

Federal deposit insurance laws.—The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) insure deposits to a maximum of $100,000 per depositor.[12] Where assets of a trust are deposits in Federally insured institutions, the trust funds are insured up to $100,000 for each beneficial owner of the funds.[13] Additionally, where a public official deposits funds required to be paid to holders of bonds issued by a public unit, the interest of each bondholder is insured up to $100,000.[14]

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[12] The FDIC provides insurance for deposits in commercial banks and State mutual savings banks. The FSLIC insures deposits in savings and loan associations, Federal mutual savings banks, and certain other thrift institutions.

[13] 12 U.S.C. sec. 1817(i) and 12 C.F.R. sec. 331(b) (FDIC); 12 U.S.C. sec. 1724(b) and 12 C.F.R. sec. 564.2(c) (FSLIC).

The FDIC and FSLIC concluded in letter rulings issued in 1982 that, where the proceeds of a tax-exempt bond issue are used to purchase certificates of deposit of insured financial institutions, which may occur in a loan to lenders programs, each bondholder's proportionate interest in the deposits would be separately recognized. Thus, if one or more depository banks failed, the interest of each bondholder would be insured up to $100,000 for each depository bank.

Typical structure of FDIC- and FSLIC-insured bonds.—In certain recent issues of tax-exempt bonds, the issuing authority has deposite the bond proceeds in bank or savings and loan accounts insured by the FDIC or the FSLIC, to be loaned to the user by the depository institution. In the typical arrangement, the issuer transfers the proceeds to a trustee for the bondholders, which deposits the funds in FDIC- or FSLIC-insured certificates of deposit. The depository institution agrees to provide the deposited funds to private users for purposes eligible for tax-exempt IDB financing. Interest and principal on the bonds are repaid from payments on the certificates of deposit. The repayment of the bonds is secured by the certificates. Because the proceeds of the bonds are used ultimately for exempt purposes, the bonds qualify as tax-exempt under present law. Because the trustee for the bondholders holds a certificate of deposit in an insured institution, the amount of each bondholder's holdings are insured to the extent of $100,000.

Small Business Administration

The Small Business Administration (SBA) is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design or installation of governmentally mandated pollution control facilities.[15] The current policy of the SBA is to avoid participation in projects financed with tax-exempt obligations. However, the House Committee on Small Business has reported favorably[16] a bill (H.R. 3020) which would prohibit SBA from declining to participate in projects because of the presence of tax-exempt financing.

Housing and Urban Development

Rental subisidies.—Section 11(b) of the Housing Act of 1937[17] provides a special tax exemption for obligations issued by State and local housing agencies in connection with low-income housing projectsd. The Act[18] prohibits the Department of Housing and Urban Development (HUD) from guaranteeing any tax-exempt obligation issued by a State or local agency. However, under certain circumstances, an issuer may pledge HUD loans or contributions (which are backed by the full faith and credit of the United States) as security for tax-exempt obligations.

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[14] 12 C.F.R. sec. 330.8(b) (FDIC); 12 C.F.R. sec. 564.8(b) (FSLIC).

[15] Small Business Investment Act of 1958, 15 U.S.C. sec. 694-1.

[16] H. Rep. No. 98-182, 98th Cong., 1st Sess. (May 16, 1983). The Senate Committee on Small Business has reported a similar bill.

[17] 42 U.S.C. sec. 1437i(b).

[18] 42 U.S.C. sec. 1437c(g).

Mortgage insurance.—In addition to the above program, the Federal Housing Authority (FHA) is authorized to insure mortgages on various properties, including certain owner-occupied housing, rental and cooperative housing, housing for moderate income and displaced families, housing for elderly persons, and hospitals and nursing homes.[19] These may include mortgages on properties construced with tax-exempt financing. In these situations, FHA-insured mortgages may be pledged as security for tax-exempt bonds.

Department of Agriculture (Farmers Home Administration)

The Farmers Home Administration (FmHA) guarantees loans for various agricultural purposes, including emergency loans, farm operating loans, farm ownership loans, soil and water loans, business and industrial loans, economic emergency loans, and guaranteed rural housing loans. The FmHA amended its regulations in 1982 to provide that FmHA will not guarantee loans made with the proceeds of tax-exempt obligations.[20] Additionally, no FmFA loan may serve as collateral for a tax-exempt issue.

Energy program guarantees

Under certain energy production or conservation programs, the Federal Government may guarantee the payment of principal or interest on IDBs used to finance qualified hydroelectric generating facilities or qualified steam-generating or alcohol-producing facilities. The Internal Revenue Code (Sec. 103(h)) eliminates the tax exemption for bonds guaranteed under these programs. Additionally, the tax exemption is eliminated when principal or interest on the bonds is to be paid with funds provided by the Federal government (or by State or local governments) under an energy production or conservation program.

Veterans' Administration

The Veterans' Administration (VA) is authorized to insure mortgages on various properties owned by veterans of the U.S. Armed Forces and their families. Those may include mortgages on certain properties constructed with tax-exempt financing. In those cases, the VA-issued mortgages may be pledged as security for repayment of the tax-exempt bonds.

Student Loan Bonds

The Department of Education guarantees repayment of various forms of student loans. In certain cases, federally guaranteed student loans may be pledged as security for repayment of tax-exempt bonds.

Tax exemptions outside the Internal Revenue Code

In addition to the tax exemptions provided under the Internal Revenue Code, certain non-tax statutes provide an exemption for interest on specified obligations. These exemptions generally are not subject to the restrictions on tax-exempt bonds contained in the Internal Revenue Code.

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[19] National Housing Act of 1934, 12 U.S.C. sec. 1707 et seq.

[20] 7 CFR sec. 1980.23.

District of Columbia Bonds

Under the District of Columbia Self-Government and Governmental Reorganization Act, Pub. L. 93-198, the District of Columbia is authorized to issue (1) general obligation bonds and (2) revenue bonds and notes for use in the areas of housing, health, transit and utility facilities, recreational facilities, college and university facilities, pollution control facilities, and industrial and commercial development. Under the Act, the obligations are exempt from all Federal and District taxation (except estate and gift taxes).[21]

The Internal Revenue Service has held that interest on bonds and notes issued by the District of Columbia is exempt from Federal income taxes notwithstanding the industrial development bond provisions of the Internal Revenue Code.[22] Thus, the District may issue bonds for industrial and commercial development without regard to the limitations on small issue IDBs. However, the bonds remain subject to an arbitrage limitation.

Possessions bonds (Puerto Rico, Virgin Islands, and Guam)

Under the Puerto Rico Federal Relations Act,[23] bonds issued by the Government of Puerto Rico, or by its authority, are exempt from Federal, State or Puerto Rican taxation. Similarly, the government of the Virgin Islands may issue tax-exempt general obligation and other bonds for public works, slum clearance, urban redevelopment or to provide low-rent housing. The government of Guam also has authority to issue obligations that are exempt from Federal, State or Virgin Islands taxation.[24]

Housing and Urban Development Bonds

Section 11(b) of the Housing Act of 1937 [25] provides special tax exemption for certain obligations issued by State and local public housing agencies in connection with low-income housing projects. The exemption is limited to projects developed, acquired, or assisted by the State or local agency. The project units must generally be rented to families whose incomes do not exceed 80 percent of the median income for the area (as determined by the Department of Housing and Urban Development).

TEFRA restrictions on private activity bonds

In addition to providing limitations on small issue IDBs (including the December 31, 1986 sunset for small issue IDBs) and on cost recovery for IDB-financed property, TEFRA made several changes in the rules concerning IDBs generally. First, TEFRA required that issuers of all private activity bonds (including IDBs, scholarship funding bonds, and bonds issued by charitable organizations exempt from tax under sec. 501(c)(3)) make quarterly information reports to the IRS concerning bonds issued by that issuer. TEFRA also required that issuance of IDBs be approved by an elected official in the issuing jurisdiction and all jurisdictions where the facilities will be located following a public hearing (or that issuance be approved pursuant to a voter referendum). In addition, the average length of time to maturity of IDBs generally was limited by TEFRA to 120 percent of the economic life of the property financed.

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[21] D.C. Code sec. 47-332.

[22] Rev. Rul. 76-202, 1976-1 C.B. 26.

[23] Laws 1917, ch. 145, 39 Stat. 953 (48 U.S.C. sec. 745).

[24] Pub. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1402).

[25] 42 U.S.C. sec. 1437i(b).

Reasons for Change

General considerations

The committee is extremely concerned with the volume of tax-exempt bonds used to finance private activities. The volume of these bonds has increased sharply over the past few years, from $6.2 billion in 1976 to $44.0 billion in 1982. During this same period, private activity bonds have increased from 21 percent of total State and local borrowings in 1975 to 51.7 percent in 1982. The TEFRA limitations on private activity bonds, including public notice and approval and information reporting requirements, limitations on cost recovery, and limitations on small issue IDBs, limited the benefits associated with certain IDB-financed projects and eliminated some of the worst abuses associated with private activity bonds. However, the TEFRA rules appear unlikely to impose adequate limits on the overall growth in the volume of private activity bonds.

The rapid growth of private activity bonds is a source of concern for several reasons. First, the mounting volume of private activity tax-exempt bonds has resulted in an increasing revenue loss (a projected $8.5 billion in 1983 from identifiable private activity bonds). Because a substantial portion of the benefits of tax exemption flows to the investor, tax-exempt bonds are a relatively inefficient means of providing a subsidy.

Second, the committee is concerned that the expanding volume of private activity bonds has inflated tax-exempt interest rates, thereby increasing the costs of State and local borrowing for traditional public purposes (schools, roads, public projects, etc). Competition from private activity bonds may thus force State and local governments to choose between raising taxes, in order to meet increased borrowing costs, or providing a lower level of services.

Finally, the availability of tax-exempt financing for certain types of projects tends to encourage investment in such projects independently of the economic value of the project. Such financing may therefore divert investment capital away from its most productive uses.

Volume caps for IDBs and student loan bonds

To prevent further unrestrained growth in private activity bonds, the committee believes that meaningful limitations should be imposed on the volume of private activity tax-exempt bonds. However, the committee continues to believe that the decision of what types of projects should be financed is best made by the appropriate State or local government. To achieve these goals, the committee decided to place statewide limits, effective in 1984, on the overall volume of private activity bonds which may be issued. The limits, set initially at $150 for each resident of the State, will apply to all industrial development bonds and student loan bonds issued within the State. (Qualified mortgage bonds have been subject to separate statewide volume limits since 1980 and the bill places qualified veterans' mortgage bonds within this volume cap.) In general, the limits are designed to prevent the national volume of private activity bonds from growing significantly beyond the 1983 volume, except to the extent that a greater need is necessary because of an increase in population.

Within the statewide limits, State and local governments will be free to issue bonds to finance activities which they determine serve the greatest public benefit within the current limitations on IDBs. The committee therefore believes that the limits will impose meaningful limits on the growth of tax-exempt bonds without impinging unnecessarily on State and local perogatives. Further, the committee believes that the limits will result in tax-exempt financing being provided to those projects which best serve the public interest.

The committee believes that private nonprofit organizations (sec. 501(c)(3)) should continue to benefit from tax-exempt financing without being forced to compete with private businesses. This is consistent with the general treatment of these organizations, which are exempt from Federal taxes and are (in most cases) entitled to receive tax-deductible contributions. Accordingly, the committee decided that bonds issued to provide financing for section 501(c)(3) organizations (other than with respect to proceeds used in an unrelated trade or business) should not be included in the statewide limits.

While desiring to limit the growth of private activity bonds, the committee believes that States which have issued bonds in excess of their statewide limits in 1983 should be allowed a reasonable period in which to adjust to the limits. The committee's bill therefore allows these States to phase down to the applicable limit so that all states are subject to the $150 beginning in 1985.

Further restrictions

In addition to the volume limits on private activity bonds, the committee believes that a number of other modifications to the rules applicable to tax-exempt financing need to be changed.

Federally guaranteed tax-exempt obligations

First, the committee is concerned by the combination of tax-exempt financing with Federal guarantees, resulting in double subsidy for certain activities. Since federally guaranteed tax-exempts are more attractive than United States Treasury securities (which are taxable) and other State and local obligations (which do not have Federal guarantees), the proliferation of such bonds may make it difficult for both the Federal and State governments to raise needed funds. The committee's bill therefore eliminates the tax exemption where a substantial portion of an issue is to be guaranteed directly or indirectly by the Federal Government. This includes tax-exempt bonds the proceeds of which are deposited in federally insured financial institutions, thereby receiving an effective guarantee. However, the committee decided that certain housing and student loan guarantees were necessary to the success of the related programs and should be exempted for the rule.

Limitations on cost recovery deductions

The committee believes that the general rule adopted by TEFRA that the cost of IDB financed property should be recovered on the straight line method over ACRS lives is appropriate because the combined benefits of tax-exempt financing and full ACRS deductions provide an unnecessarily large subsidy. The committee concluded that most of the exceptions provided by TEFRA to that rule are unnecessary. Accordingly, the committee bill removes most of the TEFRA exceptions. However, the committee concluded that multifamily housing projects financed with tax-exempt bonds should continue to be eligible for accelerated cost recovery because extraordinary levels of subsidy are generally necessary in those types of projects.

Miscellaneous changes

The committee's bill also imposes new restrictions (in addition to those imposed by TEFRA) on IDBs. These restrictions are designed, in part, to prevent the aggregation of small issue bonds so as to provide extensive amounts of financing for one large-scale project. In addition, the bill tightens the arbitrage restrictions on tax-exempt IDBs and student loan bonds by extending the arbitrage rules applicable to mortgage subsidy bonds to all such bonds, subjects tax exemptions now outside the Internal Revenue Code to Code provisions, and makes certain other changes in the law regarding tax-exempt bonds.

Explanation of Provision

1. Volume limitation on IDBs and student loan bonds

In general

The bill imposes a ceiling on the maximum amount of industrial development bonds (IDBs) and student loan bonds that each State may issue during any calendar year. The ceiling does not apply to bonds which are neither industrial development bonds nor student loan bonds (e.g., bonds issued for organizations described in section 501(c)(3) for use other than in unrelated trades or businesses).

Size of ceiling

In general, the volume ceiling is $150 for every individual who is a resident of the State as determined by the most recent estimate of the State's population by the Bureau of the Census as of the beginning of the calendar year to which the limitation applies. The $150 ceiling will continue until 1987 when the ceiling will be reduced to $100 in order to reflect the termination in present law of small issue IDBs.

Phase-in ceiling

For States whose annualized per capita issuance of IDBs and student loan bonds during the first nine months of 1983 is less than $150, a special phase-in rule applies. Under the phase-in rule, the per capita amount that such a State can issue in 1984 is equal to $150 plus one-half of the difference between the 1983 per capita issuance level and $150. Thus, by 1985, all States will be limited to the $150 per capita celing.

Allocation of limit among various governmental units

In general.—Under the bill, the State ceiling is allocated among the various governmental units within the State that can issue IDBs or student loan bonds pursuant to a three-step rule. This allocation is the same as that provided for mortgage subsidy bonds.

Under the first step, the State ceiling is allocated equally between the State (and its agencies) and localities until either the governor or the legislature makes a different allocation. One-half of the State ceiling is allocated to the State and its agencies that have authority issue IDBs or student loan bonds. The other one-half of the State ceiling is allocated to localities that have authority to issue IDBs or student loan bonds on the basis of the relative populations of those localities as determined by the most recent population estimate for the localities from the Bureau of the Census available before the beginning of the calendar year to which the ceiling relates. Where there are two overlapping local governmental units, a portion of the ceiling is allocated to the governmental unit with jurisdiction over the smallest geographical area. That portion is determined by multiplying the one-half of the State ceiling by a fraction, the numerator of which is the most recent population estimate of that governmental unit from the Bureau of the Census at the beginning of the calendar year to which the limit relates and the denominator of which is the population of the entire State using that same population data. The portion allocable to the governmental unit with jursidiction over the larger area would be equal to one-half of the State ceiling multiplied by a fraction the numerator of which is the population of the larger governmental unit not residing in the smaller govermental unit and the denominator of which is the population of the entire State.

Where two governmental units have authority to issue IDBs or student loan bonds and both governmental units have jurisdiction over the identical geographical area, the portion of the one-half of the State ceiling allocable to that area is allocated to the governmental units having the broader sovereign powers. For example, where a city and an IDB authority for the city have authority to issue IDBs, then the portion of the one-half of the State ceiling allocable to the city based upon the population of that city is allocated to the city since the city has broader sovereign powers than the IDB authority.

Under the second step, the governor of the State is authorized to allocate the State ceiling among all of the governmental units (both State and local) having authority to issue IDBs or student loan bonds. This power of the governor to allocate the State ceiling terminates after the first day of the calendar year beginning after 1983 during which the legislature of the State met in regular session or the effective date of any State legislation with respect to the allocation of the State ceiling enacted after the date of enactment of this bill.

Under the third step, the State legislature may enact a law providing for a different allocation than that provided in step one.

Under this authority, the State legislature may allocate all or any amount or portion of the State ceiling to any governmental unit in the State that has authority to issue IDBs or student loan bonds.

Special rule for home rule subdivisions.—The bill provides a special allocation rule for certain political subsidivisions with home rule powers. The home rule subdivisions to which the special allocation rule applies are those home rule subsidivisions that are granted home rule powers by the beginning of the calendar year in which the bonds are issued pursuant to a State constitution that was adopted in 1970 and become effective on July 1, 1971 (Illinois). In that State, a full portion of the State ceiling is allocated to each home rule subsidivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State, determined using the most recent population estimate from the Bureau of the Census which are available before the beginning of the calendar year to which the bonds relate using the same population data for both the State and the home rule subdivisions. The amount so allocated to home rule subdivisions cannot be altered by the power to provide a different allocation which the bill grants to the governor or the State legislature described above. However, a home rule subdivision can agree to a different allocation.

The remaining portion of the State ceiling (i.e., the State limit reduced by the amount allocated to home rule subdivisions) is then allocated among the other governmental units in the State that have authority to issue IDBs or student loan bonds under essentially the same three steps described above. Thus, under the first step, one-half of the remaining State ceiling is allocated to the State and its agencies. The other one-half of the remaining State ceiling is allocated to the localities outside of the home rule subdivisions based upon the ratio that the populations of those localities outside of home rule subdivisions bears to the population of the State's residents located outside of home rule subdivisions. Under the second and third steps described above, the governor or the State legislature can allocate the remaining State ceiling to any governmental units that have authority to issue IDBs or student loan bonds (including home rule subdivisions), but they cannot allocate the amount specially allocated to the home rule subdivisions.

Refunding issues

Under the bill, all IDBs and student loan bonds issued during the calendar year, other than certain refunding bonds, count towards the State ceiling. Refunding bonds that do not count towards the State ceiling are any obligations that are issued to refund another obligation to the extent that the refunding obligation does not exceed the then outstanding principal amount of the refunded obligation. In the case of student loan bonds, refunding bonds are not counted towards the State ceiling only if the maturity date of the refunding obligation is not later than the maturity date of the refunded obligation or the maturity date of the refunding obligation is not later than the date which is 15 years after the date on which the refunded obligation was issued (or in the case of a series of refundings, the date on which the original obligation was issued). An obligation is a refunding obligation if the proceeds of the refunding obligation are used to retire the refunded obligation within 6 months of the date of issue of the refunding obligation.

Three-year carryover

The bill provides a special rule under which a State can elect to carryover for up to three years any unused State ceiling for specific projects. Where the election applies, obligations issued in the three calendar years following the calendar year for which the election is made are not counted towards the State's ceiling for those three calendar years to the extent that the proceeds from those obligations are used to finance the project specified in the election. The unused bond ceiling is absorbed in the order in which the obligations for the specified project are issued. The election is to be made in accordance with regulations to be prescribed by the Secretary of the Treasury. Identification of a project by its address, name of intended owner, lessee, etc., and general type of facility ordinarily will be considered adequately specified. An election, once made, is irrevocable. The purpose of issuing student loan bonds shall be considered a separate project which is adequately specified for purposes of any election.

2. Denial of tax-exemption for obligations issued with a Federal guarantee

The bill provides that the exemption from Federal income tax for interest on any obligation will not apply if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof, (2) a significant portion of the proceeds of the obligation are to be used in making loans or other investments the payments on which are guaranteed, in whole or in part, by the United States of any agency or instrumentality thereof, (3) a significant portion of the proceeds of the obligation are to be invested, directly or indirectly, in deposits or accounts in a Federally insured financial institution, or (4) the payment of the principal or interest of the obligation is otherwise directly guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof. These rules apply to all obligations which are issued by or on behalf of States and their political subdivisions or otherwise would be described in section 103.

For purposes of these rules, an entity with statutory authority to borrow from the United States is to be treated as an instrumentality of the United States. In addition, a "federally insured financial institution" means any bank, credit union, mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution whose deposits or accounts are insured under Federal law.

The bill also contains a number of exceptions to this rule. First, the rule does not apply to any obligations which would be treated as Federally guaranteed solely because the loans financed with the tax-exempt bonds are guaranteed by the Federal Housing Administration, the Veterans' Administration, or the Department of Education for student loans. Second, the rule does not apply to any obligation to the extent that any proceeds of the obligation are invested in Federal obligations during an initial temporary period, during periods necessary to maintain adequate funds to meet the debt service on the obligations, or during period necessary to maintain a reasonable reserve.

3. Other limitations on use of IDBs

a. Restrictions of use of small issue IDBs where beneficiary has significant IDB use

The bill provides rules which restrict the amount of small issue IDBs that can be issued for a particular beneficiary of IDBs where that beneficiary has received the benefit of a significant amount of IDBs. Under the bill, tax-exempt small issue IDBs could not be issued if the total amount of all IDBs that would be outstanding after the issue for the beneficiary who would be the beneficiary of the small issue IDBs exceeds $40 million. In determining whether the $40 million limit has been reached, all types of IDBs are counted. However, bonds which are to be redeemed with the proceeds of the small issue IDBs are not to be counted.

b. Restrictions on use of IDBs for purchase of land or existing facilities

The bill provides that IDBs generally cannot be used for the purchase of acquisition of land or existing facilities. Existing facilities are facilities which were first placed in service prior to the purchase or acquisition which is being financed by the IDB.

The bill provides two exceptions to this prohibition. First, the prohibition on the use of IDBs to acquire existing facilities does not apply to facilities in connection with a substantial rehabilitation. Second, the prohibition on the use of IDBs to acquire land does not apply to the acquisition of farm land by a first time farmer or rancher where the cost of the acquired land is not more than $250,000. A first time farmer or rancher is an individual who previously had not materially participated in the operation of a farm or ranch which that individual owned, directly or indirectly, any part and reasonably expects to materially participate in the operation of the farm of which the acquired land is a part.

c. Denial of tax-exempt IDB financing for certain facilities

The bill provides that interest on IDBs is not exempt from Federal income tax if any portion of the proceeds of the IDB are to be used to provide any airplane, skybox or other private luxury box, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. This prohibition applies to exempt function IDBs and to small issue IDBs.

d. Extension of Internal Revenue Code rules to certain obligations

The bill extends certain of the rules in the Internal Revenue Code relating to tax-exempt obligations to bonds which are described in provisions of Federal law outside of the Internal Revenue Code. The rules extended to these obligations are the rules relating to industrial development bonds, arbitrage bonds, mortgage subsidy bonds, public approval requirements, information reporting requirements, the requirement that obligations be in registered form, and the disallowance of tax-exemption for obligations which are Federally guaranteed. Under this amendment, interest on the obligations described in those non-Code provisions would not be exempt from Federal income tax unless they complied with the rules described above.

e. Restrictions of cost recovery deductions for property financed with IDBs

The bill removes three of the four exceptions to the TEFRA rule requiring the cost of IDB-financed property to be recovered on the straight line method over the applicable ACRS period. The exceptions removed by the bill are those for certain municipal sewerage and solid waste disposal facilities, certain pollution control facilities on existing property, and certain UDAG assisted projects. Under the bill, the cost of these facilities must be recovered over the straight line method over ACRS periods. However, the cost of multi family rental housing will continue to be recovered using the accelerated cost recovery rule under the ACRS system.

f. Application of small issue IDBs to entire project

The bill provides a special rule which prevents avoidance of the limitations on small issue idbs through division of the ownership of a project. Under the rule, where two or more issues of idbs are used to finance a single building, an enclosed shopping mall, or a strip of offices, stores, or residential property which use substantial common facilities, the two or more issues are treated as a single issue for purposes of determining qualification under the small issue exception and all principal users of any of the facilities financed with the issues are treated as principal users of a single facility. Thus, under the rule, where ownership of a project is divided into several different unrelated users, qualification under the small issue exception is to be determined by measuring the capital expenditures and outstanding obligations of all the principal users of that project.

Examples of where there are common facilities include situations where there are (1) common heating, cooling and other utilities, (2) common entrances, plazas, malls, lobbies, parking, elevators, and stairways for use by employees or patrons of the facilities. In order for there to be common facilities, the two facilities used by the different users generally must be contiguous. For example, all units in a strip shopping center which use a common parking lot would be treated as a single facility (regardless of whether the strip shopping center is physically divided into more than one structure) because the structures are essentially contiguous to each other. However, two or more stores located in a downtown redevelopment project which are not contiguous to each other generally would not be treated as a single project. Structures which are separated by inconsequencial barriers, such as rights of way, are treated as contiguous for this purpose.

g. Extension of substantial user rule to all partners

The bill amends the rules of present law under which interest on IDBs is not exempt from Federal income tax to the extent that the bonds are owned by a substantial user of the facilities financed with the IDB or the holder is a related person to that substantial user. Under the amendment, all partners (including both general and limited partners) of a partnership are treated as related persons to the partnership. Thus, interest on IDBs held by any partner of a partnership that is a substantial user of the facilities financed with the IDB would not be exempt from Federal income tax.

h. Extension of mortgage subsidy bond arbitrage rules to IDBs and student loan bonds

The bill extends the arbitrage rules of present law relating to mortgage subsidy bonds to all IDBs and student loan bonds. As in the case of mortgage subsidy bonds, all IDBs and student loan bonds must comply with both the normal arbitrage rules of present law (Code sec. 103(c)) and the additional mortgage bond arbitrage rules (Code sec. 103A(i)). However, in the case of student loan bonds, the amendment continues the rule of the normal arbitrage rules that excludes payments made by the Secretary of Education pursuant to section 438 of the Higher Education Act of 1965 from the arbitrage computation. As under the present law mortgage bond arbitrage rules, fees and other charges paid by the beneficiary of the bonds are excluded if they are reasonable and would have been incurred if conventional financing were used.

i. Clarification that residential rental property may be in a mixed use structure

The bill clarifies present law to provide that facilities may be residential rental property for low or moderate income persons even though not all of the building is used for residential rental use. Thus, a building may qualify for residential rental property (described in section 103(b)(4)(A)) even though all or a portion of the bottom floor is used for commercial use. However, in such a case, only the portion actually used for residential rental use qualifies as tax-exempt financing under section 103(b)(4)(A). In addition, the Committee intends that, in determining the amount of facilities that are described in section 103(b)(4)(A), the cost of property that benefits both uses must be properly allocable between those uses. For example, where a portion of a building is used for commercial purposes and another portion of that building is used for residential rental purposes, a proper portion of the cost of the building's foundation and other common items must be allocated to the commercial use and the residential rental use.

j. Increase in amount of capital expenditures not taken into account where there is an urban development action grant

The bill increases the maximum amount of capital expenditures that are not taken into account in meeting the $10 million limit on small issue IDBs in the case of facilities to which an urban development action grant (UDAG) has been made from $10 million to $15 million. In addition, the bill codifies the rule of present law that the size of the UDAG must be at least 5 percent of the cost of the project. In determining whether the 5 percent test is met in the case of a UDAG in the form of a loan, the full amount of the loan is counted towards meeting the 5 percent test only if the rate of interest on the loan is significantly below the fair market rate and the maturity of the loan is at least 5 years. In addition, the Committee intends that this exception applies only to projects to which the UDAG was specifically made.

k. Public approval requirement in case of certain airport facilities

The bill provides a special rule under which the public approval requirement is deemed to be satisfied in the case of IDBs issued to finance a public airport where the governmental unit which is the owner or operator of the airport and is the issuer of the bonds properly approves the issue, even though all or a portion of the airport is located in the jurisdiction of other governmental units which have not properly approved the issuance of the IDBs.

Effective Dates

Private activity bond cap

The imposition of the limitation on the volume of IDBs and student loan bonds that States and their political subdivisions may issue applies to obligations issued after December 31, 1983. However, the bill provides exceptions in certain limited circumstances described below.

The bill also provides a special rule which requires that projects for which an inducement resolution (or other comparable preliminary approval) was granted before October 19, 1983, to be given priority over other projects by the issuing governmental unit which granted the inducement resoluton (or other comparable preliminary approval) out of any portion of the volume limitation that is allocated to that governmental unit. If the governmental unit granting the inducement resolution does not provide priority over other projects, the authority of that governmental unit is reduced in the next subsequent calendar year. Where there are most projects which receive priority than that governmental unit has authority to finance, the priority shall be granted in the order in which the inducement resolution (or other comparable preliminary approval) was granted. A governmental unit cannot avoid this rule by transferring all or a part of its authority to another governmental unit. However, the priority rule can be overidden by a specific State statute.

Other limitations applicable to IDBs

Restrictions on cost recovery deductions for property financed with IDBs.—The amendment which restricts the cost recovery deductions of property financed with IDBs generally applies to property placed in service after December 31, 1983, to the extent that such property is financed by the proceeds of IDBs (including a refunding obligation) issued after October 18, 1983.

However, the restrictions on cost recovery deduction do not apply to a facility placed in service after December 31, 1983, if the original use commences with the taxpayer and either—

(1) the construction of the facility had commenced before October 19, 1983, or

(2) a binding contract existed on October 18, 1983, and at all times thereafter which committed the purchaser to incur significant expenditures for construction or acquisition of the facilities.

The restrictions on cost recovery deductions also do not apply to property placed in service after December 31, 1983, to the extent that property is financed with tax-exempt bonds issued before October 19, 1983. For purposes of this exception, a refunding issue issued after October 18, 1983, generally is treated as a new issue and the taxpayer must use the slower recovery methods for unrecovered cost from the date of the refunding issue. If significant expenditures are incurred in respect of the facility before January 1, 1984, however, such a refunding issue will not be treated as a new issue and accelerated cost recovery methods may continue to be used.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the slower method and period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required upon a refinancing of a pre-October 19, 1983 issue where no significant expenditures are made with respect to the facility before January 1, 1984.

Other rules.—The other provisions of this title of the bill (i.e., those provisions other than the volume limit and the restrictions on cost recovery deduction) generally apply to obligations issued after December 31, 1983. However, under a special effective date, the portion of the provision denying tax-exemption to interest on obligations which are Federally guaranteed which relate to obigations issued in conjunction with deposits or accounts in Federally insured financial institutions applies to obligations issued after April 14, 1983.

However, these restrictions do not apply to a facility financed with the obligations if the original use commences with the taxpayer and—

(1) the construction, reconstruction, or rehabilitation of which begun before October 19, 1983, or

(2) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

Operative rules.—For purposes of the above rules, an expenditure is considered significant if the expenditure is equal to the lesser of $15 million or 20 percent of the estimated cost of the facilities. In addition, the amount of any UDAG grant preliminarily approved on April 4, 1983, shall be treated as a qualified expenditure before October 19, 1983, for purposes of satisfying the binding contract rule with respect to the facility for which such grant was so approved.

Whether or not an arrangement between a purchaser and contractor or seller constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed on October 18, 1983, however, unless the property to be acquired or service to be rendered were specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services which the taxpayer is obligated to pay for under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of items and also grants him an option or purchase additional items, the contract is binding on the taxpayer only to the extent of the items he must purchase.

A contract may be considered binding on the taxpayer even though (1) the price of the item to be acquired or services rendered under the contract is to be determined at a later date, (2) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (3) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract which was binding on the taxpayer on October 18, 1983, will not be considered binding at all times thereafter if it is substantially modified after that date. Additionaly, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a minimal amount.

Finally, all property which is part of the facilities described in the inducement resolution (or other comparable preliminary approval) adopted before October 19, 1983, pursuant to which the bonds are issued, is to be treated as under construction by October 18, 1983, where any part of those facilities are under construction before October 19, 1983. Moreover, all such property is included under these transitional rules even though part of the facilities are transferred by the taxpayer prior to their being placed in service and even though properties which are part of the facilities are placed in service before the completion of construction of other properties which are part of those facilities.

Special rules

The bill also provides special transitional rules under which certain projects are to be exempt from all of the restrictions provided by this title of the bill.

Revenue Effect

The provisions regarding industrial development bonds are estimated to increase fiscal year budget receipts by $54 million in 1984, $281 million in 1985, $746 million in 1986, $1,261 million in 1987 and $1,688 million in 1988.

C. Tax Exempt Status of Certain Educational Organizations

Present Law

Under present law, interest on State and local government obligations generally is exempt from Federal income tax.

Treasury regulations provide that State and local obligations include obligations issued by or on behalf of a State or local governmental unit by authorities empowered to issue such obligations. Treas. Reg. Sec. 1.103-1(b). The courts have held that whether an obligation has been issued by a State or local government unit depends on a variety of factors, including the degree of sovereign power exercised by the issuing authority and the relationship of the authority to the State or local government.[1] Similarly, several requirements must be satisfied in order for an issuer to qualify as a constituted authority that is issuing obligations on behalf of a State or local governmental unit. (See Rev. Rul. 57-187, 1957-1 C.B. 65; Rev. Rul. 63-20, 1963-1 C.B. 26; and Prop. Treas. Reg. sec. 1.103-1(c)(2).[2]

Reasons for Change

The committee understands that, for technical reasons, interest on obligations of the Pennsylvania State University may not be exempt from Federal income tax because those obligations may not be issued by or on behalf of the Commonwealth of Pennsylvania. The committee has examined the operations of the Pennsylvania State University and its relationship with the Commonwealth of Pennsylvania and believes that the operations of the Pennsylvania State University are sufficiently a part of the operations of the Commonwealth of Pennsylvania and its relationship to the Commonwealth of Pennsylvania is sufficiently close that interest on obligations of the Pennsylvania State University should be exempt from Federal income tax.

Explanation of Provision

The bill provides that the Pennsylvania State University is to be treated as a State governmental unit for purposes of the tax-exempt bond provisions of the Internal Revenue Code (sec. 103). Interest on obligations of the Pennsylvania State University will thus qualify for tax exemption subject to the limitations applicable to obligations issued by a State (see, e.g., sec. 103(b) and(c)). The provision does not apply with respect to trades or businesses carried on by the Pennsylvania State University which would constitute unrelated trades or businesses under the provisions regarding unrelated business taxable income (sec. 513(a)).

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[1] *Commissioner v. Shamberg's Estate*, 144 F. 2d 998 (2d Cir. 1944), *cert. den.*, 323 U.S. 792 (1945); *Philadelphia Nat'l. Bank v. U.S.*, 666 F.2d 834 (3d Cir. 1981), *cert. den.*, 102 S. Ct. 2904 (1982).

[2] In general, the proposed regulations provide that those requirements are satisfied if: (1) the authority is specifically authorized pursuant to State law to issue obligations to accomplish public purposes of the unit; (2) the unit controls the governing board of the authority; (3) the unit has either organizational control over the authority or supervisory control over the activities of the authority; (4) any net earnings of the authority (beyond that necessary for retirement of the indebtedness or to implement the public purposes or program of the unit) may not inure to the benefit of any person other than the unit; (5) upon dissolution of the authority, title to all property owned by the authority will vest in the unit; and (6) the authority is created and operates solely to accomplish one or more of the public purposes of the unit specified in the authorization of the unit.

Effective Date

The bill applies generally to obligations to which the Internal Revenue Code of 1954 is applicable.

Revenue Effect

It is estimated that this provision will reduce fiscal year budget receipts by less than $10 million annually.

TITLE VIII—MISCELLANEOUS REVENUE MATTERS

A. Capital Gain Treatment for Portion of Gain on Sale of Condominium Units Converted from Existing Structures (Sec. 801 of the bill and sec. 341(b) and new sec. 1257 of the Code).

Present Law

In general

Taxation of capital gain

Under present law, gain or loss on the sale or exchange of a capital asset is treated as capital gain or loss. If a capital asset that is held for more than one year is sold or exchanged, the resultant capital gain or loss is long-term capital gain or loss. Long-term capital gain is taxed at preferential rates.

In general, a capital asset is any property owned by a taxpayer, whether or not connected with his trade or business, other than certain exceptions. Under one of those exceptions, an asset is not a capital asset if it is stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The question of whether or not property is held primarily for sale to customers in the ordinary course of a trade or business is one of fact. Among the factors considered in making this determination are the intent of the owner; whether the sale is merely the liquidation of an investment; whether there are sales activities such as development and improvement work on the property; whether there is promotional activity such as advertising, the use of salesmen, or payment of commissions; whether the proceeds are reinvested in like property; and whether the owner is a dealer in the trade or business. In general, see *Malat v. Riddell*, 383 U.S. 569 (1966), vac'g and rem'd 347 F. 2d 23 (9th Cir. 1965).

Section 1231

Another exception to the definition of capital asset is provided for depreciable property and real property used in the trade or business (sec. 1221(2)). Under this exception, such assets are not capital assets, and the sale or exchange of such assets do not result in capital gain or loss to the seller. However, under section 1231, if the recognized gains on the sale or exchange or involuntary conversion of such assets held for more than one year (not including inventory or property held for sale to customers in the ordinary course of a trade or business) exceed the recognized losses on such sales, exchanges, or conversions, all such gains and losses are treated as long-term capital gains and losses. If such gains do not exceed such losses, than all such gains and losses are treated as ordinary gains and losses.[1]

Section 1237

Present law also provides a special rule for determining whether or not taxpayers (other than dealers in real estate) will be treated as holding real property for sale in the ordinary course of a trade or business (sec. 1237). If the requirements of section 1237 are met, and if more than five lots in the tract are sold or exchanged, then any gain realized in or after the taxable year in which the sixth lot is sold is treated as ordinary income to the extent of five percent of the sales price. Under this rule, if the first five or fewer lots are sold in any one year the entire gain on those lots is treated as capital gain.

In order to be eligible for this special treatment, the taxpayer must not have held the tract or any parcel thereof for sale in the ordinary course of a trade or business and the taxpayer must not hold other real estate for sale to customers in the ordinary course of a trade or business in the year of sale. In addition, the taxpayer must not have made "substantial" improvements (other than "necessary" improvements and certain marketing expenditures) to the tract which substantially enhance the value of the lot or parcel sold. Furthermore, the taxpayer must have held the parcel sold for 5 years (except in the case of real property acquired by inheritance or devise).

The Internal Revenue Service takes the position that section 1237 of the Code does not apply to the conversion of rental units in an apartment building to condominiums for resale to the public. Rev. Rul. 80-216, 1980-2 C.B. 239.

Collapsible corporations

In general, a collapsible corporation is one formed or availed of principally for the manufacture, construction, production, or purchase of certain types of property with the view to the sale or exchange by the shareholders of their stock (or of the liquidation of the corporation) before the realization by the corporation of a "substantial" part of the taxable income to be derived from such property. If stock in a collapsible corporation is sold, or exchanged, or the corporation liquidated, (*i.e.*, collapsed), any gain recognized by any shareholder in any such sale or exchange or liquidation which would otherwise be long-term capital gain is considered ordinary income.[2]

In the case of *Commissioner* v. *Kelley*, 293 F. 2d. 904 (5th Cir. 1961); nonacq., 1962-1 C.B. 5, withdrawn and acq. substituted, Rev. Rul. 72-48, 1972-1 C.B. 102, the Fifth Circuit held that a corporation will have realized a "substantial" part of a taxable income to be derived from the property (thereby avoiding collapsible status with respect to that property) if it realizes as little as one-third of the taxable income to be derived from the property.

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[1] For example, if a building used in a trade or business (such as an apartment building) is sold or exchanged (or condemned) and the transaction results in a gain to the taxpayer, this gain will be taxed at capital gain rates (assuming sec. 1231 gains exceed sec. 1231 losses for that taxable year).

[2] Absent this rule, shareholders could use corporations to construct or acquire ordinary income assets (such as inventory), with the intent of selling their stock or liquidating the corporation prior to the time the corporation sells the assets. Through the use of this device the shareholders would attempt to realize the value of the corporate assets from the corporation at long-term capital gain rates. In addition, if successful, this device would avoid the corporate level tax which would otherwise be imposed on the sale or exchange of the corporation's assets.

The statute provides an exception to collapsible treatment under the "70/30" rule described in Code section 341(d)(2). In general, under this rule, a shareholder who realizes gain with respect to his stock in a collapsible corporation must determine the amount of the recognized gain attributable to collapsible assets in the corporation. If this amount is 70 percent or less of his total gain, then none of the recognized gain is treated as ordinary income under the collapsible corporation provisions of the Code.[3]

Reasons for Change

The committee believes that present law is defective for several reasons. First, the committee believes that in the case where a rental property owner who holds the property for investment (as opposed to resale), subdivides the property into condominium units and sells such units in the ordinary course of a trade or business, the seller should be accorded capital gain treatment on any gain on the sale or exchange of each such unit allocable to any pre-conversion appreciation in value of the property. Second, the committee believes that present law provides an unwarranted incentive for landlords to sell their rental property to condominium converters or to engage in other transactions designed to protect the capital gain treatment for their pre-conversion accretions in value. Thus, in many cases, the effect of present law has been to require part of the income from the conversion of rental property to condominium units to be diverted to professional converters. Third, the committee is concerned that the incentives in present law to use professional converters may result in greater inconvenience to tenants. To remedy these problems, the committee's bill would allow certain taxpayers to elect to determine the character of the portion of their gain on the sale or exchange of condominium conversions attributable to pre-conversion appreciation in value as if they had sold the entire property to another person prior to conversion. In general, this would have the effect of protecting the capital nature of the property's appreciation prior to conversion.

Finally, the committee was concerned with the opportunities for avoidance of the collapsible corporation provision available to persons who sell condominium units at retail. The first means of avoidance relies on the rule in *Commissioner* v. *Kelley*, *supra*. The provisions in the bill are the proper treatment of condominium conversions and taxpayers should not be able to achieve a different result through the application of the *Kelley* case. The committee, therefore, adopted a rule which would require a corporate retail seller of condominium conversion units to realize at least two-thirds of the taxable income to be derived from the property before the property would qualify as non-collapsible.

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[3] For example, assume that corporation X owns two assets: Asset No. 1 is a collapsible condominium project just converted which has a $50 basis and a $100 fair market value. Asset No. 2 is a noncollapsible asset (either because the requisite view never existed or because one-third of the taxable income to be derived from the project has been realized) having a $50 basis and a $100 fair market value to the corporation. There is no debt in the corporation. X is entirely owned by Mr. A who has a $75 stock basis. Assume that Mr. A sells 100 percent of his stock to B in one transaction. Since 50 percent of Mr. A's gain on the sale ($62.50) is allocable to Asset No. 1, less than 70 percent of the recognized gain is allocable to a collapsible asset. Therefore, under the 70/30 rule of present law, section 341 does not apply to transmute the sale proceeds allocable to the condominium property to ordinary income, and the two-thirds rule is avoided.

The rule intended to override the *Kelley* case could in turn be avoided by use of the 70/30 rule. Accordingly, a conforming amendment was needed to prevent the avoidance by taxpayers of the two-thirds rule. Such an avoidance could take place because it is arguable under the 70/30 rule that a taxpayer could avoid collapsible treatment on the sale or exchange of his stock even though the corporation possessed a collapsible condominium conversion project less than two-thirds of the gain attibutable to which had been realized by the corporation.

While the committee believes that the present law rules should be modified to permit landlords to treat as capital gains the portion of the gain that accrued prior to the conversion of the property into condominiums, the committee also concerned that taxpayers might tend to overvalue their property, thereby overstating the capital gain portion of the ultimate sale proceeds. The committee, therefore, adopted a rule which disallows, in whole or in part, capital gain treatment if it is determined that the taxpayer substantially overvalued the property.

Explanation of Provision

New section 1257

Under the bill, in certain circumstances, a taxpayer may elect to treat a portion of the gain recognized from the sale or exchange of qualified condominium units as gain described in section 1231 (hereafter called "section 1231 gain"). This special treatment is provided even though the sale otherwise would be in the ordinary course of a trade or business. This election applies on a property-by-property basis[4] with respect to the conversion of qualified real property. Qualified real property is real property which consists of one or more structures (and the land necessary for the use of such structures) which were used in a trade or business of the taxpayer at all times during the 5-year period ending on the determination date (described below), with respect to which the taxpayer has made an election under this provision. A qualified condominium unit is any unit resulting from the conversion of qualified real property into condominium units. The election applies to the conversion of either commercial or residential property.

Under the bill, the total amount of the gain on the sale of all the units in any property which is treated as section 1231 gain (*i.e.*, the "imputed" gain) is equal to the excess (if any) of the fair market value of the property on the determination date over the adjusted basis of the property at such time, reduced by any amount which would be treated as ordinary income under the depreciation recapture provisions of sections 1245 and 1250. Any improvements to the property made in anticipation of the conversion would not be taken into account in determining the property's fair market value (or in determining its basis) on the determination date.[5] The total imputed gain amount is then allocated among each of the units in the project in proportion to their relative fair market values on the determination date.

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[4] The committee intends that, for purposes of determining the property to which an election under this bill applies, each particular property which is a unit of an integrated project involving several properties of a similar kind will be treated as a single property. See, Treas. Reg. sec. 1.341-2(a)(4).

Under the bill, this allocable capital gain amount is recognized on the sale or exchange of each unit, typically to the individual condominium purchaser. In addition, any ordinary income on the sale of the condominium inventory would be recognized at that time. If the ultimate sale of the property is for an amount less than the property's fair market value on the determination date there would first be a reduction of the imputed section 1231 gain and any additional losses would constitute ordinary losses.

In any case where the taxpayer's basis in the property is determined in whole or in part by reference to the basis of such property in the hands of another person, or when the property is acquired by inheritance or devise, the holding period and use of the property by the prior owner is combined with the holding period of, and use by, the taxpayer to determine if the 5-year rule is met. If property with respect to which an election under this section has been made is transferred and the transferee's basis is determined (in whole or in part) by reference to basis of the property in the hands of the transferor, any election under this section would continue to apply to the property in the hands of the transferee.

As used in the bill, the term "condominium" is an interest in real property consisting of two separate rights. First, the condominium unit owner must have an undivided interest in the common areas of the property and in the building. In addition, the unit owner must possess a separate right to occupy a space in the building located on the property. Finally, the condominium would have to meet the various requirements of local law relating to condominiums. See, Treas. Reg. Ss 1.528-1(b).

Under the bill, the term "determination date" would be defined as the earlier of (1) the date on which the taxpayer adopts a plan to convert the property into condominium units, (2) the day on which substantial improvements of the property are begun in anticipation of the conversion or subdivision, or (3) the day on which the form of ownership of such property is changed into condominium units. In determining the determination date, the committee expects that the Internal Revenue Service will require a filing evidencing such plan and its adoption.

The bill also provides that the amount of gain that otherwise would be treated as section 1231 gain, if an election under this provision were made, will be treated entirely or partly as ordinary income if the property is substantially overvalued on the determination date by the taxpayer on his tax return as filed. If the property is overvalued by more than 15 percent, the gain treated as section 1231 capital gain will be reduced by 20 percent for each full percentage point overvaluation in excess of 15 percent. This test is an objective one which does not require that the Commissioner show any intent to overvalue by the property owner.

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[5] Such expenditures would be treated as attributable to the ordinary income portion of the sale's proceeds (if any).

Collapsible corporations

The bill also amends the collapsible corporation provision of the Code (sec. 341) to overrule the *Commissioner* v. *Kelley, supra,* case as it applies to the sale of condominium conversions in the ordinary course of a trade or business. Under this amendment, the Code would provide that, with respect to any condominium conversion property (whether or not the property is also "qualified real property" within the meaning of the bill) which is held for resale, and which is the result of the conversion of an existing structure, a substantial part of the taxable income to be derived from such property constitutes two-thirds of such taxable income. The section 1257 election is not a condition precedent to the application of this provision of the bill. Rather, it applies to all sales of inventoriable condominium conversion units by collapsible corporations where conversion of an existing structure took place after the date of enactment in taxable years ending after that date. The provision does not apply to new structures erected specifically for sale as condominiums.

Finally, the bill provides that the 70/30 rule does not apply to any gain recognized by any shareholder on the sale, exchange, or liquidation (or other recognition event cognizable under section 341(d)(2)) of his stock if the corporation owns a collapsible condominium conversion project (subject to the provisions of the bill) at the time of the shareholder's recognition event.

Effective Date

The bill would apply to conversions after date of enactment in taxable years ending after such date.

For purposes of the effective date of the amendments to the collapsible corporation provisions a conversion is considered to take place at the earliest of the day on which the taxpayer adopts a plan to convert the property into condominium units, or the day on which the form of ownership if the property is changed into condominium units.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $37 million in 1984, $43 million in 1985, and to increase receipts by $15 million in 1986, $54 million in 1987, and $80 million in 1988.

B. No Gain Recognized from Net Gifts Made Before March 31, 1981 (Sec. 802 of the bill)

Present Law

The Federal income tax is imposed on income "from whatever source derived" (Code sec. 61). Income may be realized from a variety of indirect means as well as from direct transfers. For example, the benefit resulting from the discharge of one's indebtedness by another party constitutes gross income (sec. 61(a)(12); *Old Colony Tr. Co. v. Commissioner*, 279 U.S. 716 (1929); *Crane* v. *Commissioner*, 331 U.S. 1 (1947)).

Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Responsibility for payment of the gift tax is on the donor of the transferred property (sec. 2502), and the gift tax is determined by reference to the value of the property transferred by the donor.

In most cases, the value of the transferred property does not include the amount of gift tax paid by the donor. However, a donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer. In such cases, the amount of the gift is less than the full value of the transferred property, and the donee discharges a debt of the donor with the balance of the transferred value (i.e., a "net gift" is made).

On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner*[6] that payment of gift tax by a donee results in income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

Reasons for Change

Prior to the *Diedrich* decision, several courts had ruled that the transfer of property subject to the transferee paying any gift tax did not result in any amount realized by the transferor.[7] While the Committee believes that the *Diedrich* decision is correct, it believes that taxpayers should not be prejudiced because they may have made such transfers in reliance upon what was thought to be established law that no income tax liabilities would accrue from such transfers.

Explanation of the Bill

The bill would provide that payment of (or agreement to pay) gift tax by a donee with respect to gifts made before March 4, 1981,[8] would not result in income to the donor whose gift tax liability was thereby discharged. The provisions of the bill would apply both to Federal gift tax and to any gift tax imposed on such transfers by a State. However, the bill would not apply where the gift tax actually was paid by the donor.

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[6] 457 U.S. 191 (1982).

[7] See, for example, *Turner* v. *Commissioner*, 410 F.2d 752 (6th Cir. 1969).

[8] March 4, 1981 was the date on which the U.S. Court of Appeals for the Eighth Circuit held that the donor in the *Diedrich* case was required to recognize income from the disputed transfers.

Effective Date

The provisions of the bill would be effective on the date of enactment. The period of limitations for filing a claim for refund would be extended or reopened for up to one year after the date of the bill's enactment to permit a claim for refund to be filed in any case in which that period expired before that time.

Revenue Effect

It is estimated that the provision will reduce budget receipts by less than $5 million.

C. Disaster Loss Deduction Where Taxpayer Ordered to Demolish or Relocate Residence in Disaster Area Because of Disaster (Sec. 803 of the bill and sec. 165(k) of the Code)

Present Law

Deduction for casualty losses

The Internal Revenue Code generally does not allow a deduction for nonbusiness losses. However, taxpayers are allowed a deduction for losses not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (sec. 165(c)(3)). The deduction is allowed only to the extent that the loss from any individual occurrence exceeds $100. Additionally, the deduction is allowed only to the extent that the total amount of casualty and theft losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income (sec. 165(h)).

Treasury regulations provide that the amount which may be deducted for a nonbusiness casualty loss is equal to the lesser of (1) the difference between the fair market value of the property immediately before the casualty and the fair market value of the property immediately after the casualty, or (2) the taxpayer's adjusted basis for the property (Treas. Reg. sec. 1.165-7(b)).

Requirement of physical damage

The courts and the Internal Revenue Service have generally allowed a deduction for nonbusiness casualty losses only where the casualty (e.g. storm, flood or earthquake) caused actual physical damage to the taxpayer's property. A decline in value of property as a result of dangerous conditions, rather than physical damage, has generally been held not to be a deductible casualty loss.

For example, in *Kamanski* v. *Commissioner*, 477 F.2d 452 (9th Cir. 1973), *aff'g* 29 T.C.M. 1702 (1970), the United States Court of Appeals for the Ninth Circuit held that taxpayers were not entitled to a deduction for a casualty loss on the sale of their property following a nearby mudslide. The Court held that the decline in value of the property was not due to damage caused by the mudslide itself, but to buyers' predictions of damage from future casualties.

Timing of deduction

Casualty losses generally are deductible in the year in which the casualty is sustained. Present law (sec. 165(i)) provides a special rule for determining the timing of a deduction for a loss attributable to a disaster occurring in an area subsequently determined by the President to warrant Federal assistance under the Disaster

Relief Act of 1974.[9] Under this rule, the amount of the loss may, at the election of the taxpayer, be taken into account in determining the taxpayer's liability for the taxable year immediately preceding the year in which the disaster occurred. The election must apply to the entire loss sustained by the taxpayer.

The special rule regarding Federally assisted disaster areas concerns only the timing of deductions. Thus, under present law, a taxpayer residing in a disaster area must establish the existence and amount of any loss under the general principles applicable to all taxpayers.

Reasons for Change

The committee is concerned that, in the case of certain natural disasters, casualty loss deductions have been allowed to taxpayers whose residences have been physically destroyed by the disaster, but not to taxpayers whose residences have been condemned because of a threat of further destruction, or because their residences have otherwise been rendered uninhabitable by the disaster. This occurs under present law even though both these groups of taxpayers are denied further use of their residences, and are subject to immediate and substantial economic loss, as a direct result of the disaster. The committee believes that these similarly situated classes of taxpayers should receive similar tax treatment. The committee further believes that the tax laws should not act to discourage the evacuation of dangerous residences by State and local authorities. Accordingly, the committee decided that a deduction should be allowed to taxpayers who are ordered to demolish or relocate their residences as a proximate result of disaster conditions, whether or not the residences have been physically damaged.

In making the determination above, the committee is aware of the rule that allows nonbusiness casualty loss deductions only for sudden, unexpected losses, and denies a deduction for gradual declines in property values. The committee is also aware of the administrative difficulties that may result from too broad an expansion of the casualty loss deduction. Because of these considerations, the committee decided to place several limitations on the deduction allowed by the bill. First, the deduction is limited to residences located within a Federally declared disaster area. Second, a deduction is allowed only where the demolition or evacuation order is made by the appropriate State or local government, within a specified period. Finally, the deduction is limited to cases in which the taxpayer's residence has been rendered unsafe as a proximate result of the disaster. These requirements are designed to ensure that the deduction allowed by the bill remains consistent with the general rules for deducting nonbusiness casualty losses.

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[9] P. L. 93-288, 93d Cong., 2d Sess., May 22, 1974 (42 U.S.C. sec. 5121 *et seq.*).The Disaster Relief Act of 1974 empowers the President to declare an area affected by a disaster (including storms, floods, earthquakes, landslides, mudslides, hurricanes, tornadoes, fires and explosions) either an "emergency" or a "major disaster" area. The declaration of an emergency permits the Federal government to take immediate steps to protect life, health and property, and to provide various forms of emergency assistance. Where a major disaster is declared, the Federal government is authorized to provide various additional forms of assistance, including financial assistance (such as grants and loans) to private parties affected by the disaster.

Explanation of Provision

The bill provides that certain taxpayers whose residences are located in an area determined to warrant Federal assistance under the Disaster Relief Act of 1974, and who are ordered to demolish or relocate their residences, may deduct any loss attributable to the disaster that caused the demolition or evacuation order as a casualty loss. The deduction is allowed for taxpayers (1) who are ordered by the State or local government, not later than 120 days after the Federal determination, to demolish or relocate their residences, and (2) whose residences have been rendered unsafe for use as a residence by reason of the disaster.

The committee intends that a deduction will be allowed only when a residence is rendered unsafe as a proximate result of the disaster (including storms, floods, earthquakes, mudslides, earthslides, hurricanes, lightning, and tornadoes). That is, the residence must be rendered materially more dangerous after the disaster than it was before the disaster, and the danger must be from a materially increased risk of future destruction arising from the disaster. For example, in a storm disaster area, a demolition or relocation order based on a finding that a residence was rendered unsafe by nearby mudslides would result in a deductible loss. By contrast, the decline in value of a residence as a result of pre-existing dangerous conditions (*e.g.*, by reason of location in an historically storm-prone region) would not result in a deductible loss, even if the house is condemned.

The amount of any loss deductible under the bill is to be determined under the general rules applicable to nonbusiness casualty losses. Thus, the amount deductible equals the lesser of (1) the difference between the fair market value of the property immediately before the disaster and the fair market value of the property immediately after the disaster, and (2) the taxpayer's adjusted basis for the property. (The deduction would be reduced by any amount realized upon a condemnation sale.) In the case of a relocated residence, fair market value immediately after the disaster is to be determined based on the value of the residence prior to relocation. For example, if a residence has a fair market value of $100,000 immediately before a disaster, and a fair market value of $20,000 immediately after the disaster, the taxpayer would realize a loss of $80,000 (or, if less, an amount equal to the adjusted basis of the residence), regardless of the value of the residence in any new location. As under current law, the component of loss in value due to any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the disaster is not deductible.

Amounts deductible under the bill are subject to the timing provisions of existing law for disaster losses. Thus, at the taxpayer's election, these amounts may be deducted on the taxpayer's return for the taxable year immediately preceding the year in which the order to demolish or relocate the residence was made.

Effective Date

The bill applies to taxable years beginning after December 31, 1981, with respect to areas determined after that date to warrant Federal disaster assistance.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $15 million in 1984; $12 million in 1985; $12 million in 1986; $13 million in 1987; and $13 million in 1988.

D. Foreign Investment Companies (Secs. 804-806 of the bill and secs. 535, 1092 and 1246 of the Code)

Present Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation on only their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income. A special rule applies, however, to income from the sale of commodities and futures contracts. Foreign corporations are taxable on their gains from the sale of commodities and futures contracts only when those sales are effectively connected with a trade or business in the United States. In general, by avoiding contacts with the United States, a company purchasing and selling commodities and futures contracts on U.S. markets may be able to avoid conducting a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)). In that event, gains from sales of commodities and futures contracts are exempt even though they have a U.S. source.

Dividends from one foreign corporation to another foreign corporation are taxable only if 50 percent or more of the paying foreign corporation's income from the last three years is U.S. business income, in which case the dividends are U.S. source income (in the same proportion as the gross income is U.S. business income) (sec. 861(a)(2)(B)).

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The Subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend. For this purpose, tax haven activities generally include gains from trading in futures contracts in commodities. However, the Subpart F rules apply only if more than fifty percent of the voting power in the foreign corporation is owned by U.S. persons who own (directly or indirectly) at least ten percent interests in the corporation. (Even if ownership is so concentrated that the Subpart F rules apply, the rules apply only to those U.S. persons who are considered to own ten percent or more of the voting power in the foreign corporation.)

Two other, similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. shareholders to current taxation on passive investment income or futures trading income, but these rules apply only if five or fewer U.S. individuals own (directly or indirectly) more than fifty percent in value of the stock of a foreign corporation. In general, only one of these three sets of rules will apply to tax that income.

The accumulated earnings tax

The accumulated earnings tax is aimed at corporations accumulating income for the purpose of avoiding tax at the shareholder level. The accumulated earnings tax (which reaches a maximum rate of 38.5%) generally applies to a U.S. or foreign corporation formed or availed of for the purpose of avoiding the U.S. income tax on shareholders by accumulating earnings at the corporate level rather than distributing earnings.

Under Treasury Regulations, the tax does not apply to foreign source income (Treas. Reg. sec. 1.532-1(c)). It may be unclear whether a foreign parent corporation and a foreign subsidiary corporation (earning U.S. source income) from which the foreign parent receives dividends are subject to this tax, however. If the subsidiary distributes all its U.S. source earnings as dividends to its parent, those dividends are generally deductible from accumulated earnings. Therefore, there may be no accumulated earnings at the level of the subsidiary to which the accumulated earnings tax can apply. The parent corporation may avoid the accumulated earnings tax because all of its income is foreign source income (such as dividends from its subsidiary) not effectively connected with a U.S. trade or business.

The Internal Revenue Service may argue in such a case that imposition of an accumulated earnings tax on the earnings of either foreign corporation is appropriate. First, the statute and the Regulations allow imposition of the accumulated earnings tax if the avoidance of tax at the shareholder level is accomplished through the use of a chain of corporations. (See Treas. reg. sec. 1.532-1(a)(2).) Second, the Code gives the Secretary authority to disregard certain tax benefits associated with a corporation if the corporation was acquired for the principal purpose of evading or avoiding Federal income tax (sec. 269).

Shareholder level tax on disposition of the investment

Code rules attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower capital gains rates after deferring tax on those earnings. Gains of a U.S. person who was a ten-percent shareholder (during a five-year period) in a controlled foreign corporation on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (sec. 1248). Wide dispersal of a foreign corporation's stock ownership can avoid controlled corporation status.

Another provision, the foreign investment company provision (sec. 1246), generally applies to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities (as generally defined in that Act) when more than 50 percent of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's earnings and profits. A foreign corporation that does not register under the Investment Company Act avoids the first of these criteria. In addition, certain case law holds that commodities do not constitute securities for purposes of that Act, so that a company that is engaged primarily in the business of investing or trading in commodities may avoid the second criterion.

Marking-to-market of futures trading income

The Economic Recovery Tax Act of 1981, Public Law 97-34, adopted a mark-to-market rule for the taxation of certain commodity futures contracts (Code sec. 1256(a)). Thus, each regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. A maximum rate of 32 percent applies to this income. U.S. taxpayers investing through a pass-through entity (such as a limited partnership) organized in the United States in such futures contracts would be subject to this mark-to-market rule.

Foreign corporations not engaged in U.S. trade or business are not subject to tax under the mark-to-market rule.

Straddles

The Code defines a straddle as offsetting positions with respect to personal property. Personal property is defined to include only property (other than corporate stock) of a type which is actively traded. A taxpayer is treated as holding offsetting positions with respect to personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property.

Generally, the deduction of losses on positions that are part of a straddle is limited to the amount by which those losses exceed unrecognized gains on any offsetting positions. Some taxpayers have deliberately arranged to hold offsetting positions indirectly through ownership of stock in corporations owning those positions to avoid the straddle rules. That is, a shareholder seeks to deduct losses despite unrecognized gains in the hands of the corporation that offset the shareholder's losses. Often, the corporations involved in the transactions are foreign, so as to avoid U.S. tax on the gains.

Reasons for Change

A mutual fund may, using some of the rules described above, attempt to defer U.S. tax and to convert trading income (ordinarily taxed as 60 percent long-term gain and 40 percent short-term gain) to 100 percent long-term capital gain through the use of two foreign corporations, one of which ("the Parent") owns all the shares of the other ("the Subsidiary"). The fund establishes and operates these foreign corporations in tax haven jurisdictions, which impose no tax on their operations.

U.S. taxation of foreign persons

The Parent may trade in non-U.S. commodity markets (and will avoid having any U.S. source income), while the Subsidiary will trade in U.S. commodity markets (and will earn all the U.S. source income that either corporation earns). In general, by carefully structuring its activities, the Subsidiary may be able to avoid having a business in the United States and thus avoid U.S. tax on gains from commodity trading activities (sec. 864(b)(2)(B)).

The Parent may be able to avoid U.S. tax because it will be a foreign corporation with no U.S. source income. Its income will consist mainly of (1) dividends from the Subsidiary, which should not be U.S. source, and (2) gains from trading on non-U.S. commodities markets, which will result in foreign source income.

Taxation of U.S. shareholders of foreign corporations

The fund may plan to avoid U.S. shareholder level tax on the earnings of the Parent and the Subsidiary by having the Parent distribute no dividends. Shareholders will have to dispose of their shares to receive any income.

To decontrol these corporations for purposes of the anti-tax avoidance rules including the controlled foreign corporation rules, the Parent will restrict transfers of its shares, and it will attempt to spread ownership of its shares by U.S. persons among many such persons.

Accumulated earnings tax

The fund may plan its operations so as to try to avoid the accumulated earnings tax. It may try to benefit from the general rule that the tax does not apply to foreign source income. This is one of the primary reasons to set up two foreign corporations (the Parent and the Subsidiary) rather than one. The parties involved will argue that the Subsidiary will not be subject to the tax because it will distribute all its U.S. source earnings as dividends to the Parent. The fund will argue that there are no accumulated earnings at the level of the Subsidiary to which the accumulated earnings tax can apply. The fund seeks to avoid the accumulated earnings tax at the level of the Parent by having all the Parent's income be foreign source income.

The validity of these positions under current law, however, is unclear, and the Internal Revenue Service may argue that imposition of an accumulated earnings tax on the earnings of the Parent or the Subsidiary is appropriate.

To avoid potential challenges to its position on the accumulated earnings tax, the fund may allege that its corporate structure has no tax avoidance purpose. The issue would be one of intent.

Shareholder level tax on disposition of the investment

Under this plan, the shareholder realizes income from the investment by disposing of the interest in the offshore corporation rather than by being paid the earnings. A major element in this plan is to permit U.S. investors in the fund to realize capital rather than ordinary gain from their investment when they sell. Such treatment would circumvent the Code's rules that attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower long-term capital gains rates after deferring tax on those earnings. The fund would plan to avoid this rule by causing such wide dispersal of the Parent's stock ownership as to avoid controlled foreign corporation status.

The fund would plan to avoid the foreign investment company provision (sec. 1246) by failing to register the Parent or the Subsidiary under the Investment Company Act and by relying on case law that holds that commodities do not constitute securities for purposes of that Act.

Marking-to-market of futures trading income

U.S. investors could avoid the mark-to-market rule by interposing foreign corporations between themselves and the investments. A similar result could be achieved through the use of a domestic corporation at the investor's level, but the corporation would be subject to the mark-to-market rules.

Committeee concerns

The committee is concerned that the abusive use of tax havens by U.S. persons through transactions like those described above, poses a significant threat to the U.S. tax base. While the committee recognizes legitimate uses of tax haven entities, it also recognizes that any use of tax haven entities must be carefully scrutinized. Particularly troublesome are those cases in which U.S. taxpayers use a foreign entity, which is not much more than a conduit, to shield U.S. income from U.S. tax.

Such a situation has come to the attention of the committee with the result that the committee has reviewed certain anti-abuse provisions of the Code and has found loopholes that should be closed. In particular, the committee believes that for purposes of insuring that investment income of a U.S.-controlled foreign investment company cannot be converted to capital gain, no distinction should be made between security transactions and other investment transactions. Accordingly, the committee expanded the scope of the foreign investment company rules.

Also, the committee believes it inappropriate to defer U.S. tax on the U.S. earnings of a foreign company, or to permit mere receipt of U.S.-source income by a foreign corporation and its payment to another foreign corporation controlled by U.S. persons to change the source of that income. Accordingly, the committee has amended the accumulated earnings tax rules to insure U.S. tax in such cases.

Finally, the committee believes that transparent devices, such as the use of a corporation to avoid the straddles rules, cannot be tolerated.

Explanation of Provision

1. Definition of foreign investment company (sec. 804 of the bill and sec. 1246 of the Code)

The bill expands the definition of "foreign investment company" (sec. 1246), for purposes of determining when gain on the sale of shares of that stock will be ordinary rather than capital. A foreign investment company will include any foreign corporation that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons. For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. If that definition in the Investment Company Act is amended in the future, then the definition for Internal Revenue Code purposes will also change. A primary effect of this provision is to bring commodity trading companies within the definition of foreign investment company. The bill will generally not affect the treatment of foreign corporations registered under the 1940 Act.

Effective date.—The provision will generally apply to sales and exchanges (and distributions) after September 29, 1983. In the case of shares held on September 29, 1983, and held continuously thereafter by one taxpayer until sale, exchange, or distribution, however, the bill will apply to sales and exchanges (and distributions) made after one year after date of enactment.

2. *Extension of accumulated earnings tax to U.S.-owned foreign corporations (sec. 805 of the bill and sec. 535 of the Code)*

The bill makes it clear that U.S. persons cannot use two or more tiers of foreign corporations to avoid the accumulated earnings tax on certain U.S. earnings. For purposes of the accumulated earnings tax rules (secs. 531-537), if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year are derived from sources within the United States or are effectively connected with the conduct of a trade or business within the United States, then any distribution received (directly or indirectly) by a United States-owned foreign corporation out of those earnings and profits will be treated as derived by the receiving corporation from sources within the United States. That is, the earnings retain their U.S. source or U.S. connection in the hands of the receiving (upper-tier) corporation, so that they will be subject to the accumulated earnings tax. A similar rule applies to interest paid by a foreign corporation. If the paying corporation meets the 10-percent earnings and profits threshhold, all interest it pays to a U.S.-owned foreign corporation is U.S. source income for the purpose of the accumulated earnings tax.

The bill defines the term "United States-owned foreign corporation" to mean any corporation if 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by

U.S. persons. The bill will apply only to foreign corporations. It will apply to closely held and publicly held foreign corporations alike.

Effective date.—This provision will apply to distributions received by a United States-owned foreign corporation on or after May 23, 1983. In the case of a foreign corporation that was a United States-owned foreign corporation on May 23, 1983, however, the provision will first apply in the first taxable year of the foreign corporation that begins after December 31, 1984.

3. *Treatment of offsetting position stock* (sec. 806 of the bill and sec. 1092 of the Code)

The bill expands the definition of personal property, for purposes of the straddle rules (sec. 1092), to include offsetting position stock. It defines offsetting position stock to mean any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders. This rule applies to both U.S. and foreign corporations. Therefore, a taxpayer would be required to defer losses if offsetting position stock contained unrealized gains for him or her.

Effective date.—This provision applies to positions established after May 23, 1983.

Effective Date

The effective dates for these provisions are included above in the "Explanation of Provision."

Revenue Effect

The provisions will increase fiscal year budget receipts by less than $10 million annually.

E. Application of Cash or Deferred Arrangement Rules to Pre-ERISA Money Purchase Plans (Sec. 807 of the bill, and sec. 401(k) of the Code)

Present Law

In general

A money purchase pension plan is a defined contribution plan under which each participant's pension benefit is based solely on the balance of the participant's account, consisting of contributions, income, gain, expenses, and losses. Profit-sharing plans are also defined contribution plans.

Under a cash or deferred profit-sharing plan, or under a money purchase pension plan with a salary reduction arrangement, the employer gives an employee the choice of (1) receiving a specified amount in cash as current compensation or (2) having that amount contributed by the employer to the plan.

In December 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of cash or deferred profit-sharing plans and money purchase pension plans with salary reduction arrangements. (These proposed regulations were withdrawn in July, 1978.) Under the rules in effect at the time of the proposal, an employee generally was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan or salary reduction money purchase pension plan. Under the proposed regulations, amounts contributed to a plan by the employer due to the election of the employee would be included in the employee's income.

Freeze on tax treatment

In order to allow time for Congressional study of this area, the Employee Retirement Income Security Act of 1974 (ERISA) provided that the tax treatment of contributions to cash or deferred profit-sharing plans or salary reduction money purchase plans in existence on June 27, 1974, was to be governed under the law as it was applied prior to January 1, 1972. Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the tax-qualification rules. Under ERISA, this freeze in tax treatment was continued through 1976, or (if later) until regulations were issued in final form which would change the pre-1972 administration of the law. The freeze was subsequently extended through 1979.

Revenue Act of 1978

The Revenue Act of 1978 provided rules for new and old profit-sharing plans with cash or deferred arrangements. The new rules, which also apply to stock bonus plans, are effective for plan years beginning after 1979. For years beginning before 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Reasons for Change

The committee is concerned with the revenue loss associated with the increasing use of salary reduction agreements in connection with cash or deferred arrangements. The committee believes, however, that permanent rules should be provided for a pre-ERISA money purchase pension plan with a salary reduction feature as long as these plans are maintained at the pre-ERISA contribution levels.

Explanation of Provision

The provision revises the tax-qualification rules to permit a qualified money purchase pension plan which was in existence on June 27, 1974, and which provided for a salary reduction arrangement on that date, to continue the arrangement after 1979. However, this revision to the tax-qualification rules will apply only to those money purchase pension plans under which employer and employee contributions may not exceed the limits (*e.g.*, the percentage of pay) provided under the plan's contribution formula on June 27, 1974.

In addition, for plan years beginning after 1983, a salary reduction arrangement under a money purchase pension plan must meet the special tax-qualification rules for cash or deferred arrangements added by the 1978 Revenue Act with respect to employee eligibility to participate in the arrangement and to prohibited discrimination in favor of employees who are officers, shareholders, or highly compensated. These rules presently apply to cash or deferred arrangements under qualified profit-sharing or stock bonus plans.

The provisions of the bill apply to salary reduction arrangements under money purchase pension plans of taxable employers and tax-exempt organizations.

Effective Date

The bill will apply for plan years beginning after December 31, 1983. The rules in effect prior to ERISA will apply for plan years beginning after December 31, 1979, and before January 1, 1984.

Revenue Effect

It is estimated that this provision will have a negligible effect on budget receipts.

TITLE IX—SOCIAL SECURITY DISABILITY BENEFITS REFORM ACT OF 1983

A. Purpose and Scope

The committee's bill also amends Title II of the Social Security Act to provide for necessary reforms in the administration of the social security disability insurance program. The disability insurance program has attracted substantial Congressional attention over the last two years, primarily because of the numbers of beneficiaries whose benefits have been terminated. The review of current beneficiaries that has produced these terminations was mandated by Congress, but was accelerated in pace in March, 1981. There has been no suggestion that those receiving disability benefits should never be examined again, but the committee believes that the process over the last several years has resulted in erroneous termination of benefits for at least some people.

Therefore, the committee's bill addresses three major areas where reform appears to be most critically needed: in the standards for determining eligibility for disability benefits, both for new applicants and more particularly for current beneficiaries being reviewed; in the structure of the administrative process itself; and in the way in which the Social Security Administration makes disability policy, both on its own initiative and in conjunction with rulings of the Federal courts. There are in addition several miscellaneous provisions concerning payments to vocational rehabilitation agencies, publication of policies concerning consultative medical examinations, and establishment of new positions for social security staff attorneys.

The overall purpose of the bill is, first, to clarify statutory guidelines for the determination process to insure that no beneficiary loses eligibility for benefits as a result of careless or arbitrary decision-making by the Federal government. Second, the bill is intended to provide a more humane and understandable application and appeal process for disability applicants and beneficiaries appealing termination of their benefits. Finally, the bill seeks to standardize the Social Security Administration's policy-making procedures through the notice and comment procedures of the Administrative Procedures Act, and to make those procedures conform with the standard practices of Federal law, through aquiescence in Federal Court of Appeals rulings.

The committee is deeply concerned about the erosion of public faith and confidence in the social security disability programs, and in the agency as part of the Federal government, that has occurred as a result of the changes in policies over the last several years. The guidelines established in this bill appear to the committee to be the best way to restore confidence in the program. The committee believes it is crucial to continued public support for the social security program as a whole for the public to understand that the program will be administered according to the law rather than by constantly shifting and possibly arbitrary policies.

B. Explanation of Provisions

1. Standards of disability (secs. 901-903 of the bill)

a. Overview

Sections 901-903 of the bill are designed to clarify the criteria that must be used in evaluating whether new applicants or current beneficiaries are disabled. The criteria laid out in present law are few, and brief:

(1) Disability is defined in Section 223(d)(1) of the Social Security Act as the inability to engage in any substantial gainful activity by reason of a medically determinable impairment which can be expected to result in death or to last at least 12 months;

(2) A second sentence added in 1967 expanded on this definition with respect to the type of work an individual must be unable to perform, i.e., not only his previous work but, considering his age, education and work experience, any work existing in the national economy, regardless of the existence of any specific job he might actually be hired for.

The committee does not intend to alter the current definition, which embodies the intent of Congress that only those who are verifiably unable to work are to be found eligible for disability benefits. However, it must be recognized that determining inability to work in each individual case must ultimately rest to some degree on the subjective judgment of the examiner.

In response to this inherent subjectivity, the disability determination process has developed into an elaborate system of checks and balances designed to prevent individual judgment from outweighing national policies defining who is totally disabled. The initial decision is made according to the submitted clinical findings, a deliberate paper decision that avoids as much as possible the personal influence of either the claimant or of his physician. The examiner's decision is then subject to several different kinds of reviews, through the quality assurance system and through a multilayered appeals system, in an attempt to ensure as much objectivity as possible in an inherently subjective decision.

The process each examiner follows in making disability decisions at the State agency level is known as the "sequential evaluation" process. After checking to see whether the claimant is currently working at the substantial gainful activity (SGA) level, the examiner next must determine whether the individual has a severe impairment; if he does not, the process goes no further.

SSA has been criticized for using the severe/non-severe test at this stage of the process as a way to terminate benefits, or deny initial applications without fully evaluating the person's real ability to work. This criticism has been particularly strong in the case of multiple impairments, because the regulations require that where the person has several impairments, of which none are severe, no disability can be found.

At this step and later on in the process, current policy is to take subjective evidence of pain into account only if objective medical data, such as laboratory tests and documented case history, show a specific impairment that can reasonably be concluded to be causing the pain. This policy is an attempt to ensure that a finding of disability is based only on "medically determinable" impairments, as required by the statutory definition, and to reduce the level of subjectivity inherent in the disability determination.

After finding that the person has a severe impairment, the examiner must determine whether that impairment matches the listings of disabling impairments or if, in combination with other less severe conditions, the total impairment equals the severity level in the listings (the "meets or equals" test). If it does not, the examiner must assess the person's "residual functional capacity" — ability to do either his past work or any other work in the national economy. SSA evaluates work capacity in a variety of ways, using all available evidence of work or productive activity in sheltered workshops, home settings and competitive work environments.

This evaluation is difficult to make for beneficiaries who have been receiving benefits for some time, particularly for those with mental impairments, whose illness may allow certain types of activity with limited circumstances, but possibly not under the day to day pressure of a real job. SSA has been particularly criticized for not giving sufficient weight to the longitudinal medical and work history of mentally impaired claimants.

In summary, SSA's current policies for interpreting the definition of disability place a heavy emphasis on objective evidence to support a finding of disability. The sequential evaluation is designed to create a series of clear decisions for the examiner, particularly as to the severity of the impairment, which are to be made based only on verifiable clinical data, so that the subjectivity of the decision can be kept to a minimum.

While this process allows tighter control over the number of people allowed benefits, and therefore over program costs, it can result in denial of benefits for people who cannot be expected to work in view of their total condition. The definition of disability clearly states that benefits are to be paid to those who are unable to work because of a severe impairment, not merely to those who meet a certain impairment level and incidentally are unable to work. The current procedures thus represent a compromise between complete evaluation of every individual's particular circumstances, on one hand, and, on the other, a completely objective "screen" of characteristics which must be satisfied in order to find a person disabled.

The committee wishes to reaffirm that the purpose of the disability insurance program is to provide benefits only for those who are unable to work. It is therefore completely appropriate for the Social Security Administration to periodically review beneficiaries who are not deemed to be permanently disabled, in order to ensure that the law is being carried out.

However, the committee is concerned that the consideration of eligibility for disability benefits be conducted using criteria that clearly reflect the intent of Congress that all those who are unable to work receive benefits. It is of particular concern that the Social Security Administration has been criticized for basing terminations of benefits solely and erroneously on the judgment that the person's medical impairment is "slight," according to very strict criteria, and is therefore not disabling, without making any further evaluation of the person's ability to work.

The committee believes that in the interests of reasonable administrative flexibility and efficiency, a determination that a person is not disabled may be based on a judgment that the person has no impairment, or that the impairment or combination of impairments are slight enough to warrant a presumption that the person's work ability is not seriously affected. The current "sequential evaluation process" allows such a determination, and the committee does not wish to eliminate or seriously impair use of that process. However, the committee notes that the Secretary has already planned to re-evaluate the current criteria for non-severe impairments, and urges that all due consideration be given to revising those criteria to reflect the real impact of impairments upon the ability to work.

It is also assumed that the length of time the beneficiary has been on the benefit rolls will be taken into account in assessing the person's residual functional capacity. The committee is concerned that the periodic review of beneficiaries who are over age 50, and who have been on the benefit rolls for some period of time, may result in termination of benefits for many in that age group who realistically cannot be expected to re-enter the work force given their age and length of time in receipt of benefits. Therefore, the committee directs the Secretary to re-evaluate the consideration given in the determination process for such beneficiaries to past relevant work, in order to ensure that older beneficiaries who have been receiving benefits for several years are carefully reviewed for realistic ability to work.

The committee is also concerned that the evaluation of the person's ability to work be made in a context that accurately reflects the capacity to work in a normal, competitive environment. Such an evaluation does not necessarily require a full "work evaluation" by a vocational expert in each case, although such evaluations are desirable and should be used wherever feasible where the additional information provided by such evaluations would be helpful in deciding close cases. The committee particularly urges that such evaluations should be used if at all possible in cases of mental impairment, where necessary to aid in determining eligibility in "borderline" cases, at the point in the sequential evaluation process where such evaluations would normally be done under current policy.

It is also important in such cases to evaluate the person's entire work history, rather than to examine only recent evidence of work activity, in order to determine whether the person can really engage in substantial gainful activity. The committee emphasizes that in any evaluation of work activity, the presence of work in a sheltered setting or workshop cannot in and of itself be used as conclusive evidence of ability to work at the substantial gainful activity level. Such work may be used in conjunction with other evidence that the beneficiary or claimant is not disabled, but benefits should not be denied simply because of sheltered work experience.

The committee emphasizes that the foregoing discussion does not constitute any change in the current definition of disability, but rather is a clarification of the intent of Congress that disability benefits should be granted to those who are unable to work because of a medically determinable impairment. Sections 901 and 903 of the bill provide statutory standards for determining disability: section 901 establishes specific criteria for re-examination of current beneficiaries, while section 903 establishes criteria for multiple impairment cases both on initial application and on re-examination. Section 902 mandates a study and recommendations on the possible use of subjective evidence of pain in determinations of disability, with a view toward establishing standards in this area through legislation after consideration of the report. Taken together, these new statutory standards will provide much needed clarification of the law and of Congressional intent.

The committee also wishes to emphasize that the social security disability insurance program is a Federal social insurance program, fully funded by the disability insurance trust fund (including State and Federal administrative costs), and administered by the Social Security Administration. While disability determinations are made by State disability agencies under voluntary agreements with the Department of Health and Human Services, policies for making these evaluations are and must be established at the Federal level, for implementation on a nationwide basis.

The committee is aware of the actions several States have taken in response to conflicting interpretations of the applicable provisions of law relating to the termination of benefits — actions which, in effect, represent a failure to comply with certain policies issued by SSA. While such actions must be regarded as questionable, the current confusion that has given rise to them is understandable and creates a compelling need for congressional clarification. We believe the relevant issues would be resolved by this bill and that, as a result, the basis for any such actions would be eliminated.

The committee bill makes clear what the law is with regard to certain areas of contention such as the standard for medical improvement. With respect to the area that is not so clarified, i.e., the use of subjective evidence of pain in disability determinations, the intent of Congress is clear: upon receipt of information adequate to form a reasonable basis for legislating, Congress will enact a specific policy concerning pain; until that time, no change in policy by the Social Security Administration is mandated by this bill.

b. Standard of review for terminations of disability benefits (sec. 901 of the bill)

Section 901 of the bill provides for the first time in the social security statute a specific standard that must be met before a disability beneficiary can be found to be not disabled. SSA has always scheduled a certain percentage of disability beneficiaries for re-examination to determine whether they are still disabled. The statute contains no guidelines for appropriate criteria to govern these re-examinations, other than the definition of disability.

From 1969 to 1976, SSA's policy, established originally by an administrative law judge in one hearing, was to not terminate benefits for anyone whose condition had not improved since the initial determination of eligibility. This policy was reversed in 1976 in internal SSA directives. Shortly thereafter, the Supreme Court, in *Matthews v. Eldridge*, agreed with the agency that the burden of proving continuing eligibility for benefits was on the beneficiary.

However, possibly as a result of the pre-1975 policy, a decreasing number of people seemed to be leaving the benefit rolls to return to work in the 1970's — the rate of benefit terminations due to recovery or return to work fell from 32 percent per thousand beneficiaries in 1967 to 16 persons per thousand in 1975. As a result, Congressional interest was expressed, beginning in 1978, in requiring SSA to look at people who had been receiving benefits for a long time to see if they were still eligible. SSA's standard procedures for re-examining only a small number of beneficiaries seemed to be inadequate in light of the declining number of benefit terminations for return to work.

The 1980 Social Security Disability Amendments made a number of significant changes in disability program operations. Responding to the need for more effective management of the program, the legislation required a dramatic increase in the amount of management review and oversight of the program, with the objective of tightening central Federal control over State agency and ALJ decisions, and re-invigorating ongoing review of current beneficiaries. Of particular concern in connection with Section 901 of the bill was the provision requiring review at least once every three years of all beneficiaries not permanently disabled, beginning in January, 1982.

However, the Department of Health and Human Services moved up the date of implementation of this provision, and accelerated the rate of review of current beneficiaries beyond the schedule required in the 1980 Amendments. Beginning in March 1981, SSA began sending out about three times the normal number of CDI cases: about 160,000 were done in FY 1981, 496,771 in FY 1982, and 640,000 were budgeted for FY 1983 prior to the Secretary's new initiative to slow down the review process announced in June, 1983.

The rate of terminations in these CDI cases at the initial level currently is about 45 percent, which is very close to the rate for re-examinations done in previous years. However, the types of cases being examined in the accelerated CDI process are different from the relative few cases SSA used to designate for re-examination because they had great potential for medical recovery.

The new caseload consists in large part of beneficiaries who were not scheduled for re-examination before, and who in many cases were found disabled several years ago, during and after the inauguration of the SSI program, when the decision criteria may have been less precise than those being used today. The magnitude of the CDI initiatives has meant that a very large number of the cases SSA considers were wrongly allowed (either by the original State examiner or by an ALJ overturning the State agency) are being re-examined for the first time since the policy change on medical improvement in 1976.

These re-evaluations are based on current standards and medical criteria which are in many cases more clear-cut and exact than the standards on which benefits were initially based, and reflect improvements in medical technology and treatment. Moreover, the overall "adjudicative climate" has been generally more rigorous than in earlier years, so that re-examined beneficiaries, now being looked at as if they are new applicants, will have more rigorous standards applied than in their initial determination. For example, beneficiaries who originally were allowed benefits because their combination of impairments roughly approximated the level required by the medical listings ("equals the listings"), are now more likely to be evaluated according to whether their impairment matches the medical criteria ("meets the listings"), which are themselves different from the criteria in 1970.

It has been alleged that the agency, particularly in mental impairment cases, has focused too heavily on the severity of the medical condition without making an adequate evaluation of the beneficiary's ability to work, with the result that benefits have been terminated for many people who cannot function in a work environment. These policies seem to have been in effect well before the inauguration of the accelerated review in 1981, but the combination of an apparently more restrictive policy and reviews of large numbers of beneficiaries have resulted in widespread complaints about SSA's procedures.

These policies have come under severe criticism in Federal courts, particularly in the Ninth Circuit Court of Appeals which has ruled twice that SSA must demonstrate either medical improvement or (in the later ruling) clear and specific error in the original award, in order to terminate disability benefits. Similar "medical improvement" standards have been declared in other circuit courts as well, and an increasing number of State governors have declared those judgements to be binding on ALJ's and State adjudicators in opposition to Federal policy guidelines.

In summary, the re-examination of large numbers of current disability beneficiaries has resulted in termination of benefits for many beneficiaries whose medical condition has not changed substantially since they were allowed benefits. Medical impairments are being closely examined to determine whether they meet today's standards — if the impairment is now judged to be not severe, the person's benefits are terminated, whether or not the impairment is any different from when the person was first allowed. The primary issue therefore is whether a person's benefits should be terminated because standards of disability have changed since the individual was first allowed benefits, so that he is judged able to work under current criteria even though his medical condition has not improved.

The committee recognizes that the problems with the current review have arisen, at least in part, because the criteria for termination of benefits as a result of review were left unstated in the law. SSA has therefore had wide discretion to apply whatever standards it deemed appropriate — and since the standards of the current program apparently are stricter than those in the past, applying today's standards has meant eliminating benefits for many more beneficiaries than was anticipated when the 1980 Amendments were enacted.

Therefore, section 901 of the bill establishes a clear "medical improvement" standard that creates a category of beneficiaries who, because their medical conditions have not improved, are presumed to be unable to work and who therefore must continue to receive benefits. This standard contains several important exceptions which would allow termination of benefits even where the beneficiary's medical condition has not improved: where the beneficiary is performing substantial gainful activity, where medical or rehabilitation techniques allow the person to work despite his unchanged condition, where the original decision was in error, or was fraudulent, or where new or improved diagnostic techniques or evaluations reveal that the impairment is less disabling than originally thought.

The committee believes these exceptions address several legitimate concerns: that benefits which were improperly allowed originally should not be continued; and that the documented effects of medical or vocational therapy on an individual's ability to perform SGA, and the result of a reassessment of the severity of an individual's impairment based on the application of new or improved diagnostic or evaluative techniques need to be taken fully into account in making continuing disability determinations. The committee emphasizes, however, that the application of these exceptions is contingent on the satisfaction of specified requirements relating to documentation, the acquisition of appropriate medical and vocational evidence and the use of specified techniques or procedures. Thus, with respect to the effect of medical or vocational therapy on an individual's ability to perform SGA, the exception would be applicable only if it is demonstrated, on the basis of new medical evidence and a new assessment of the individual's residual functional capacity (RFC), that the individual has been the recipient of services which reflect advances in medical therapy or technology (or the recipient of any vocational therapy) which has had the effect of restoring the individual's ability to engage in SGA.

Similarly rigorous requirements must be satisfied with respect to the use of the exception relating to the results obtained from the application of new or improved diagnostic or evaluative techniques which may disclose that the individual's impairment is less disabling than originally thought at the time of the prior determination (for example, the individual has the ability to do his previous work, that is, usual work or other past work). The committee recognizes that there may be some cases in which the prior decision that the individual was disabled was based, in part, on an assessment of residual functional capacity that was either improperly or inadequately documented. While it might be argued that in such cases a finding of clear error ought to be made, it is not intended that the standard of "clearly erroneous" be loosely applied to encompass inadequate development of a case. Moreover, the cases involved here do not represent "erroneous determinations"; rather, they reflect decisions properly made in accordance with the state of the art at the time the decisions were made and in accordance with the administrative procedures in place at that time. The fact is, however, that changing methodologies and advances in medical and vocational diagnostic and evaluative techniques have given rise to improved methods for documenting and evaluating medical evidence, RFC, and vocational factors. Where such methods, properly used, permit the development of more accurate, objective and valid results, they should not be ignored.

The committee intends that where SSA uses new or improved evaluation techniques to determine and document an individual's ability or inability to work, and where this new determination shows that an individual is not as disabled as initially considered (for example, the individual can do his previous work), such evidence may serve as the basis for a finding under this section that the individual is not disabled within the meaning of Title II of the Social Security Act.

The committee expects that this exception will be carefully applied and that any determinations made in accordance with this provision will be fully documented, accurate and consistent with objective medical and vocational findings. Since these cases may involve individuals who have been receiving disability benefits in good faith, the committee re-emphasizes here that it expects the Secretary to re-evaluate the consideration given in the continuing disability process to factors such as age and duration in benefit status. Nonetheless, when appropriately and responsibly applied, this exception is available to assure the equitable attainment of the objectives of the program.

The committee is aware that in some cases adjudicated in prior years all the medical information relevant to the initial decision may not still be in the beneficiary's file and that such a situation would preclude the possibility of making an objective finding with respect to a change in the severity of be beneficiary's impairment. In such cases, SSA would be authorized to secure such medical information as may be necessary to fully reconstruct the medical records and data that were utilized in making the initial decision. The committee emphasizes, however, that the inability to reconstruct such records and data cannot serve, in and of itself, as a basis for a determination that there has been medical improvement. Such a conclusion may be reached only if the records applicable to the initial decision have been fully reconstructed and the prior and current medical evidence discloses that there has in fact been medical improvement.

c. Study concerning evaluation of pain (sec. 902 of the bill)

The social security statute currently provides no guidance on the use of allegations of pain by the claimant in the disability determination process. Because the definition of disability states that inability to work must be "by reason of a medically determinable impairment", the Social Security Administration has allowed allegations of pain to be used only if a specific physical impairment exists to which the pain can be reasonably attributed.

However, many claimants allege disability primarily or substantially as a result of disabling pain that cannot be specifically attributed to a physical condition. Because the law itself is not explicit, allowance decisions at the ALJ and Federal court levels have not infrequently depended heavily on this kind of subjective evidence. Almost every circuit court of appeals has ruled at some point over the last ten years that eligibility should be based on subjective evidence of pain, at least in cases where it is corroborated by testimony of other witnesses.

The committee is concerned that a fragmented standard is now in effect for using subjective evidence of pain, depending on whether the beneficiary has pursued his claim through the ALJ or district court level. While it may well be the case that pain in and of itself, regardless of its cause, can result in inability to work, there is apparently still no way to verify the existence of such pain through objective medical testing.

The committee is therefore reluctant at this time to allow determinations of disability to be based on such subjective criteria. There is plainly a critical need for a clear legislative policy, to be applied to all cases on a nationwide basis; it is not appropriate for the Federal courts to establish policy on such an issue simply because the statute is insufficiently specific. However, the committee cannot, at this time, mandate such a policy, simply because there is not enough information about the impact this kind of change would have on the types of cases that would be allowed and on the costs to the disability program.

Therefore, section 902 of the bill requires the Secretary in conjunction with the National Academy of Sciences, to conduct a study on the question of using subjective evidence of pain in determining disability, and on the question of the state of the art of preventing, reducing or coping with pain, and to report to the Congress by April 1, 1985 on the results of the study. It is anticipated that at that time, Congress will be able to develop a satisfactory statutory standard.

The committee also directs the Secretary to conduct such studies as are necessary to obtain complete information and statistics on both the fiscal costs and administrative feasibility of eliminating the 5-month waiting period for disability benefits for persons diagnosed by their physicians as terminally ill with less than 12 months to live. The results of such studies shall be presented to the Congress no later than October 1, 1984.

d. Multiple impairments (sec. 903 of the bill)

Under current law, the first step in the sequential evaluation process through which the disability determination is made is to determine whether the applicant has a severe impairment. If SSA determines that a claimant's impairment is not severe, the consideration of the claim ends at that point. In cases where a person has several impairments, none of which meet the standard for "severe", he is judged not disabled, without any further evaluation of the cumulative impact of his impairments on his ability to work.

The committee believes that this does not represent a realistic policy with respect to persons with several impairments which may in many cases interact and effectively eliminate the person's ability to work. While it is clear that the determination of disability must be based on the existence of a medically determinable impairment, there are plainly many cases where the total effect of a number of different conditions can safely be characterized as disabling, even if each by itself would not be. Section 903 of the bill therefore requires that in determining whether an individual's physical or mental impairment or impairments are so severe as to be disabling, SSA must consider the combined effect of all the individual's impairments without regard to whether any individual impairment considered separately would be considered severe.

2. Disability determination process (secs. 904–908 of the bill)

a. Moratorium on mental impairment reviews (sec. 904 of the bill)

Serious questions have been raised by Federal courts, professionals in the fields of psychiatry and vocational counseling and the General Accounting Office about the adequacy of SSA's current Listings of Mental Impairments and the appropriateness of SSA's current methods for assessing residual functional capacity and predicting ability to work in individuals with mental impairments. While the validity of all these criticisms may be subject to some debate, it is clear that in many cases individuals have been improperly denied benefits. Moreover, the Secretary has determined that a full scale re-evaluation of the Listings and current procedures is necessary and, on her own motion, has imposed a moratorium on reviews of mental impairment cases classified as functional psychotic disorders. However, the moratorium imposed by the Secretary does not include all mental impairment cases that will be affected by changes in the listings and procedures, does not provide a precise timetable for the review and resolution of the pertinent issues and does not stipulate how the results of these changes are to be subsequently implemented.

The committee agrees that a moratorium of the kind imposed by the Secretary is warranted. However, the committee is concerned about the need to establish clear guidelines with respect to the review process, the timeframe for conducting the re-evaluation and procedures for the disposition of cases, including new applications and prior CDI's in the categories affected by the moratorium. The purpose of section 904 is to provide these guidelines.

Under section 904 a temporary delay would be imposed on reviews of all mental impairment cases until the Secretary revises the criteria embodied under the category "Mental Disorders" in the "Listing of Impairments." The revised listings and procedures for assessment of residual functional capacity are to be designed so as to realistically evaluate the ability of a mentally impaired individual to engage in substantial gainful activity in a competitive environment. Regulations establishing such revised criteria and listings are to be published no later than 9 months after enactment. Moreover, the Secretary is required to conduct this re-evaluation and to prepare the appropriate regulations in consultation with the Advisory Council on Medical Aspects of Disability (created under section 912 of the bill).

This delay of reviews would apply to all CDIs of mental impairment cases upon which a timely appeal was pending on or after June 7, 1983 or on which no initial decision has been rendered as of the date of enactment, unless the individual is engaged in substantial gainful activity or fraud is involved.

Initial cases denied during the moratorium period are to be reviewed by the Secretary as soon as feasible after the new criteria are established, and those with mental impairments who were denied benefits or had their benefits terminated between March 1, 1981 and the date of enactment will have their cases reopened as of the most recent prior determination if they reapply within one year. Benefits would be paid as of the date of reapplication but the individual's insured status would thus be protected.

The committee is cognizant of the fact that revision of the listings in the mental impairment area could potentially result in an increase in the cost of the disability program. For that reason, the committee intends to monitor closely the cost effects of these revisions and directs the Secretary to report to the Committee on Ways and Means and the Senate Committee on Finance on the cost effects of any proposed changes in the listings 30 days in advance of the implementation of the regulations.

b. Face-to-face hearings in State disability determination agencies (sec. 905 of the bill)

Decisions as to whether or not an individual is disabled are made by 54 State disability agencies under agreements with SSA. These decisions may be appealed. Currently a disability claim or a CDI may go through five or more decision levels:

(1) The initial decision by the State agency, which if adverse can be appealed to

(2) the reconsideration level, also conducted by the State agency, which if adverse can be appealed to

(3) the Federal administrative law judge hearing, followed by, if adverse,

(4) an appeals council review; and finally

(5) if all prior decisions are adverse, the claimant can file an appeal in the Federal court system.

Under present law, the Federal Administrative Law Judge (ALJ) is the first level at which the disabled individual meets face-to-face with a decisionmaker. Initial interviews are conducted in SSA district or branch offices (of which there are about 1300) when the individual first applies or is first called in for a CDI, but no decisions are rendered there.

Even though no decisions are rendered in the social security district office, the committee recognizes the importance of the initial interview a CDI beneficiary or new applicant receives there. The district office has traditionally played a major role in assuring a full explanation of the program, of the individual's rights, the procedures involved, and in providing assistance to the individual in pursuing his or her claim.

P.L. 97-455 mandated that by January 1, 1984, individuals whose benefits are terminated due to a medical review (CDI) must be given the opportunity to have a face-to-face evidentiary hearing at the reconsideration level conducted either by the Secretary or the State agency. Although it may be necessary for logistical reasons for the Secretary to implement this provision in many areas of the country through the use of SSA hearings officers, the committee would encourage the Secretary to offer State agencies the option to conduct these face-to-face hearings. Since, under the provisions of the committee's bills, this reconsideration hearing would be only a temporary transitional procedure which would be phased out as the State agencies implement a face-to-face interview at the initial

State agency decision level, State agencies could acquire valuable experience in conducting the transitional reconsideration hearing.

There is virtually unanimous agreement about the desirability of providing for a face-to-face meeting between the disability beneficiary and the administrative decisionmaker. The committee believes that such a meeting at the initial stage in the adjudicative process would permit State agency disability examiners to better assess the individual's residual functional capacity and assure that all relevant medical and vocational information has been obtained. Moreover, an interview at the initial State agency level, rather than at some later stage, would both simplify and expedite the decisionmaking process.

Consequently, section 905 provides for the implementation, no later than January 1, 1985, of face-to-face evidentiary interviews by all State disability agencies at the initial decision level for all medical termination cases. Under this provision, the State agency would send the beneficiary a preliminary notice of an unfavorable decision and the claimant would have 30 days in which to request a face-to-face meeting before a formal determination is made. The present reconsideration level would be abolished upon implementation of the State interviews. The committee emphasizes that where it is possible it would prefer that this provision be implemented earlier than January 1, 1985, and that where this occurs the transitional reconsideration hearings would be terminated.

The committee also endorses the concept of instituting face-to-face hearings at the initial, State level, and of abolishing the reconsideration level, for initial claims as well as CDI review cases. However, it is recognized that this procedure would be a complicated and major change for the program necessitating further study and preparatory administrative planning. As a result, section 905 also requires the Secretary to initiate demonstration projects with respect to face-to-face evidentiary meetings at the initial level of State agency determinations for new applicants and requires the Secretary to report to the Congress by April 1, 1985, on these projects. These projects must be conducted in a minimum of five States with the participating States to be selected no later than January 1, 1984. Where the projects are initiated, the reconsideration level would be eliminated.

The committee emphasizes that, where feasible, these demonstration projects should be implemented prior to the dates in the bill and notes that some States have expressed a strong interest in testing out this procedure. Since the committee is concerned that there be a full and cooperative effort made to implement and carry out all phases of a face-to-face interview in initial cases, the committee believes it would be appropriate to use these particular States in the demonstration projects.

c. Payment of benefits during appeal (sec. 906 of the bill)

P.L. 97-455, passed by Congress in December 1982, included a provision to allow beneficiaries whose benefits had been ceased because of a medical review of their eligibility to elect to continue receiving benefits until an ALJ has rendered a decision on the case. If the case is denied, then the benefits, except for Medicare, are subject to recoupment (subject to the hardship waiver standards already in law). This provision, however, was adopted on a temporary basis only—until further consideration could be given to the CDI issue in the 98th Congress. Thus, under present law, no extended payment can be made after June 1984 and the provision applies only to cessations occurring before October 1, 1983. For cessations after that date the program will revert to prior law which provided benefits for the month of cessation and two additional months. Since January approximately 113,000 individuals have elected to continue benefit payments during appeal.

Section 906 provides on a permanent basis for the continuation of benefits during appeal in all CDI cases through the decision of the Administrative Law Judge. Where the ALJ's decision is adverse to the beneficiary, such benefit payments would be subject to recoupment as under present law. The Secretary also must report to the committee on Ways and Means and the Committee on Finance by July 1, 1986, on the impact of this provision on expenditures from the social security and Medicare trust funds and the rate of appeals to ALJs. The committee believes, based on the experience under the present temporary provision, that providing for continuation of payments during appeal helps considerably to ease the severe financial and emotional hardships that would otherwise be suffered by disabled persons.

In addition, it is recognized that beneficiaries may be reluctant to elect to receive continued benefit payments for fear of not being able to repay the benefits provided if the decision of the Administrative Law Judge is unfavorable. The committee intends that at the time beneficiaries are given the opportunity to make this election they be informed that, in the event of an unfavorable determination, they might be eligible for a waiver or for a long-term repayment plan. The committee further intends that the Secretary take into account individual circumstances in making a determination as to whether or not to waive the overpayment.

d. Qualifications of medical professionals (sec. 907 of the bill)

A shortage of qualified medical personnel has been a chronic problem in the social security disability program. Knowledgeable medical consultation is necessary for accurate decisions, and particular concerns have been raised that in the area of mental impairments a general medical knowledge is often not sufficient for a full evaluation of an individual's claim. The committee notes that through the encouragement of the Social Security Administration almost all State agencies now have staff psychiatrists available.

Section 907 requires that where there is an unfavorable decision in a mental impairment case, a qualified psychiatrist or psychologist must complete the medical portion and the residual functional capacity assessment of the determination. The committee believes that this requirement will help assure an accurate determination of the individual's capacity for substantial gainful activity.

The committee would also encourage the Social Security Administration to urge States to secure qualified specialists in other areas of impairments and to examine methods (such as referrals to nearby States or to the SSA central office) for providing consultation with specialists where that would be helpful but is not locally available. The committee notes that requiring States to hire physicians in all specialties would be costly and in some States impossible. Nonetheless, the committee believes efforts should be made, to the extent feasible, to provide disability examiners with the expert consultation of specialists wherever that would be helpful in making an accurate decision.

In this and other areas the committee notes that efforts to gather every piece of evidence must be balanced against the time and resources required to do so. If the disability judgment takes too long or becomes too fraught with complicated procedures for gathering evidence it would be criticized on those grounds. Indeed, some courts have interposed time limits on how long the agency can spend in reaching a decision. Given the already substantial administrative costs of the program and the constraints imposed by individual States on securing additional personnel, the availability of resources is also a real consideration since imposing requirements for which there are not adequate resources generally causes additional disruption of the program—the opposite effect from that intended.

Nevertheless, concerns have been expressed that in an effort to process cases in an expeditious manner, procedures have been followed by SSA which inhibit the full development of medical and other evidence and which made it more difficult for disabled claimants fully to state their case.

The committee emphasizes the need to examine all relevant evidence in making a disability determination and the need to actively seek and pay particular attention to evidence from treating physicians, especially in chronic illnesses. SSA and State agency personnel share an obligation to assist the claimant in understanding the process and securing necessary medical data. The committee, therefore, requests that the Secretary report to the Congress on the current use of home visits by agency personnel and on whether there are other instances where a home visit would not now occur but which might be constructive in providing the agency with full information on a claimant.

Similarly, the committee is concerned that hearings locations (and face-to-face interview locations) be accessible to beneficiaries. Such offices should be located in buildings fully accessible to the handicapped; funding for medical evidence and travel should be provided, and the Social Security Administratin should re-examine the current requirement that a beneficiary must travel at least 75 miles in order to qualify for travel reimbursement as this standard may be inappropriate in many locations in this country.

e. Regulatory standards for consultative examinations (sec. 908 of the bill)

Consultative examinations are medical examinations purchased by the agency from physicians outside the agency to secure medical information necessary to make a determination or to check conflicting evidence. Many concerns have been raised about the improper or generally unsupervised use of CE's and SSA has taken several steps to tighten up procedures in this area and particularly to restrict the use of doctors providing CE's on a volume basis (volume providers).

The committee is pleased to note that efforts are being made to provide more direction in the use of consultative examinations and would encourage SSA to redouble its efforts to secure reasonable fee structures for consultative examinations so that dependency on volume providers can be reduced. The committee also believes, however, that concerns about the use of consultative examinations would be lessened if policies now in effect with respect to consultative examinations (or any subsequent policies that may be developed in this area) were embodied in regulations. Section 908, therefore, requires that the Secretary promulgate such policies in regulations. Since the purpose of this provision is only to assure that the policies are published in regulations there is no intent or implication that any new claims or pending cases involving consultative examinations be delayed until the regulations are published. On the contrary, it is the committee's intent that such cases will continue to be processed and adjudicated as under present law.

The committee also notes that questions have been raised about SSA's application of the trial work provision of present law. In order to eliminate any possible misunderstanding or confusion about the intent of this provision, the committee reaffirms that recency of work and sustained work over several consecutive months is necessary for an individual to meet trial work conditions.

3. Miscellaneous provisions (secs. 909-913 of the bill)

a. Uniform standards for disability determinations (sec. 909 of the bill)

Section 553 of the Administrative Procedure Act of 1946 established basic requirements for informal rulemaking, the process by which most regulations today are promulgated. This section requires general notice of proposed rulemaking to be published in the *Federal Register*, and an opportunity for public comment during a period of at least thirty days prior to the effective date of the rule. There are general exceptions to these requirements for interpretative rules, statements of policy, and rules of agency procedure, organization or practice, and where the agency for good cause finds the notice and comment procedures impractical or contrary to the public interest.

Social security benefits are not covered under Section 553 by virtue of an exception in Section 553(a)(2): "a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts." This exception was part of the original APA, which was enacted at a time when there were very few Federal benefit programs: the social security disability and Medicare programs did not exist, and requirements for old age and survivor benefits were fairly explicit in the statute. In 1971 then-Secretary of HEW (now HHS) Elliot Richardson issued a statement placing all HEW programs voluntarily under the APA rule-making requirements.

However, SSA has continued to issue, as do other agencies such as the Internal Revenue Service, other policy statements, notably Social Security Rulings and the disability claims manuals (POMS), which are supposed to contain only clarification and interpretation of the policy contained in regulations. In addition, it has been alleged that real operating policy often develops as a result of State disability examiner reaction to return of specific allowance decisions deemed incorrect by SSA's Federal quality assurance reviewers. None of these sources of policy are open to public notice or comment.

The Bellmon Report on the hearings and appeals process, mandated by the 1980 Disability Amendments, found wide discrepancies in standards applied by the administrative law judges who are bound by the statute and regulations, as opposed to those applied by the State agencies who are bound by the POMS. This discrepancy may be a major reason for the high reversal rate of State agency denials at the ALJ level (standing at around 55 percent currently). As a result of this report, and the even higher reversal rate for CDI cases, there has been considerable pressure for uniform criteria at all levels of adjudication. SSA's response to this pressure was to begin incorporating the POMS into Social Security Rulings, which by regulation (20CFR 422.8) are to be relied upon as precedents in cases where the facts are essentially similar by ALJ's as well as State agencies.

The original exception for social security to Section 553 notice and comment requirements appears to have been more an accident of history than deliberate Congressional intent concerning all social security programs. When the APA was enacted, the disability program did not yet exist, and there were as yet very few social security beneficiaries of any sort.

Elimination of the APA exception for benefits has been recommended by the American Bar Association, and such a change has been incorporated in H.R. 2327, currently under consideration by the Judiciary Committee (a similar provision was previously approved by the Senate). There appears to be widespread agreement concerning eliminating just the exemption in 553(a)(2) for public benefits. There appear to be considerably greater complications in any changes to section 553(b)(A) which allows interpretive statements to be issued without public notice and comments. The Judiciary bill provision for limiting the exemption in 553(b)(A) for interpretative rules has been the subject of extensive debate for some time, and the bill retains the good cause exception in 553(b)(B).

The committee believes that it is appropriate for changes in policies that affect whether or not people receive disability benefits to be published in regulations allowing for public participation in the process. The policy decisions that must be made concerning disability determinations are far more complex than most policies in the old age and survivor programs, for one major reason: the determination of ability to work is an inherently difficult eligibility decision, while eligibility for retirement benefits depends on factors of age, quarters of coverage, and current earnings that are relatively easily determined.

However, the agency should also have sufficient flexibility to respond to changes in conditions quickly, and to issue administrative guidance to State agencies on a timely basis. There is clearly an appropriate role for issuance of informal policy clarification through rulings or other informal vehicles, and the committee has no wish to deprive the Social Security Administration of this ability.

Therefore, section 909 of the bill requires that the notice and comment provisions concerning issuance of regulations of section 553(a)(2) of the Administrative Procedures Act be applied to benefit programs under Title II. The provision does not affect the application of the exception in section 553 allowing informal policy clarifications to be issued through non-regulatory statements.

The committee emphasizes that the intent of the provision is to provide uniform standards for decision-making at all levels of the disability determination process, through the normal channels of rule-making that allow some degree of public participation in the process. In order to allow SSA some degree of flexibility in administering the extremely complex disability program, the bill allows the current practice of issuing Social Security Rulings to continue. However, it cannot be too strongly emphasized that the intent of the provision in eliminating the first exception is that all policy that substantially affects the determination of eligibility must be the same for all levels—State agency through administrative law judge—and must be issued through regulations.

This provision does not address directly the problem of informal policy direction given to State agencies through the quality assurance process. It may be difficult to prevent returns of cases to the State agency from having an effect on overall adjudicative policy, particularly as the agency begins to review sixty-five percent of all favorable decisions. However, the committee intends Section 909 of this bill to produce uniform policy at all levels arrived at through processes open to public scrutiny. It is therefore expected that the Social Security Administration will take all steps necessary to limit the influence of quality assurance systems on day to day operations and policy of State agencies.

The committee is [illegible] aware of the grey area that exists between issues clearly having substantial policy impact that plainly belong in regulations, and [illegible] clearly minor, administrative or merely clarifying that plainly belong in informal policy statements. It will be necessary, therefore, for the committee to closely monitor SSA's activities with respect to this provision to assure that misunderstandings do not arise and that the desired ends are achieved. All administrative law relies heavily on the presumption that agencies will perform their duties in good faith, and the committee is, to a certain degree, relying on the expectation of good faith efforts by the agency to promulgate uniform standards through the regulatory process. If after some period of experience, it is found that this section has not had the desired effect of producing uniform standards, further measures will be considered.

b. SSA compliance with certain Federal court decisions (sec. 910 of the bill)

Under the Federal judicial system, decisions by a circuit Court of Appeals are considered the "law of the circuit," and constitute binding case law to be followed by all district courts in that circuit. In general, if two circuits rule differently on a particular issue, the Supreme Court will review the issue to settle the dispute. The application of Supreme Court decisions to executive branch policies is virtually undisputed: if a particular policy is found unconstitutional, or contrary to the statute, that decision is binding on the agency. The appropriate application of circuit and district court decisions to agency policies is not as clear-cut.

Claimants for benefits under the Social Security Act may appeal State agency denials through several layers of administrative appeal, up through the appeals council. A claimant who wishes to continue to pursue appeal may next turn to the Federal district court with jurisdiction over his or her claim. The district court reviews the record as compiled by the agency to determine whether substantial evidence existed for the agency's decision. The district court's review is not a trial de novo, but rather is limited to a consideration of the pleadings and the transcript of the proceedings at the ALJ hearing. If the district court finds substantial evidence existed to support the agency's decision to deny benefits, a claimant may appeal the decision to the circuit court with jurisdiction, and ultimately petition the Supreme Court for certiorari.

Appeals of the agency's determinations to the Federal district courts are occurring with much greater frequency in recent years, imposing a workload burden on some district courts. Between 1955 and 1970, the total number of disability appeals filed with the Federal district courts was about 10,000 cases. In 1982 alone, nearly 13,000 disability cases were appealed to the district courts. The large increase in Federal court litigation on social security matters may be partly responsible for the present tension between SSA and the lower Federal courts.

Most disability cases decided in the Federal courts have little value as precedent for SSA decisions, since most reversals of agency determinations rest on the lack of substantial evidence for the agency's position. However, in many instances the court's opinion sets forth a statutory interpretation contrary to that of the agency, in the traditional manner in which Federal courts establish a rule of law, which is intended to be binding on the agency in later cases concerning the same issue. Circuit courts of appeals decisions in such cases have been issued with increasing frequency in recent years, with the clear expectation of the court that SSA would abide by its interpretation as would normally be the case with rulings having precedent as law within the circuit.

The Social Security Administration does not follow U.S. Courts of appeals decisions with which it disagrees, either nationwide or within the circuit of the ruling. While the agency does obey the court's ruling in the particular case being adjudicated, the interpretation of law from the court is not considered binding by the agency either for State disability agency operations or for Federal social security offices.

Moreover, the agency frequently does not appeal district court or circuit court opinions with which it disagrees. This practice ensures that the Supreme Court will not have the opportunity to review the issue and render a decision with which the agency would be compelled to comply. Social security ALJ's are not able to follow court of appeals decisions as precedent if the Supreme Court does not make a ruling or if the agency does not incorporate the circuit court's decision in social security rulings or regulations, which is most often the case in decisions SSA disagrees with.

SSA has been criticized for this policy, both by outside experts and Federal judges, on the grounds that it undermines the structure of Federal law, and in essence allows SSA to overrule the legal judgment of the Federal courts by administrative inaction. SSA defends its policy on the grounds that a Federal benefit program should be administered uniformly on a national basis. It should be noted that in a brief before the Supreme Court in *Califano v. Yamasaki* (1979) the brief for petitioner Secretary Califano stated the following:

> When a statutory or constitutional issue is decided adversely to the Secretary in the course of judicial review obtained by an individual claimant, the Secretary will either appeal or abide by the unfavorable ruling. Repetitious litigation will thus not be necessary in order to establish a general legal principle applicable beyond the confines of a particular case. *Stare decisis* will impel the Secretary to follow statutory or constitutional decisions within the jurisdiction of the courts having rendered them.

This statement is in marked contrast to the repeated instances brought to the committee's attention of SSA's non-acquiescence policy, summed up in the following statement from the Associate Commissioner for Hearings and Appeals issued to Social Security ALJ's in January, 1982:

> The Federal courts do not run SSA's programs, and [SSA's adjudicators] are responsible for applying the Secretary's policies and guidelines regardless of court decisions below the level of the Supreme Court. (Social Security memorandum to its Administrative Law Judges)

Since 1978, there have arisen numerous cases in which circuit courts of appeals have ruled on issues where the Title II or XVI statute is unspecific or silent, most notably the issues of use of allegations of pain in disability determinations, and of whether a beneficiary whose condition has not medically improved can be found not disabled. Every circuit court of appeals in the country with the exception of the D.C. circuit has ruled that subjective evidence of pain must be allowed in finding claimants eligible for benefits. Several circuits, including the Ninth Circuit in two separate opinions, have ruled that SSA must show that a beneficiary has medically improved before ruling him no longer disabled. In all of these cases, SSA has not applied the court interpretation of the statute beyond the litigated case, and has not pursued an appeal to the Supreme Court.

The committee is concerned about the result of this non-acquiescence policy for claimants, the courts and SSA. First, while it is clearly of utmost importance that a Federal program be administered according to uniform, Federal standards, it is not clear that SSA's non-acquiscence policy substantially achieves that end. In fact, under the current policy, distinctions exist *within* circuits between policies applied to those claimants who pursue their claims to the appeals court level, and those who cannot. Such a difference will be particularly significant in those circuits where a class action suit applying to several thousand claimants is successful.

The committee is most concerned about the impact of this policy on beneficiaries and claimants, and on their relationship to the social security program. If a circuit court rules on a given issue such as medical improvement, it is a foregone conclusion that subsequent appeals to that court on that issue will be successful. By refusing to apply the circuit court ruling, SSA forces beneficiaries and applicants to re-litigate the same issue over and over again in the circuit, even though the agency is certain to lose each case.

The committee can find no reason grounded in sensible public policy to force beneficiaries to sue in order to obtain what has been declared by the Federal court as justice in a particular area. Such a policy creates a wholly undesirable distinction between those beneficiaries with the resources and fortitude to pursue their claims, and those who accept the government's original denial in good faith or because they lack the means to appeal their case. The strength of the social security program has always rested on the public perception that the agency's mission is to provide benefits to all those entitled to them, without undue delay or bureaucratic barriers. The increasingly adversarial character of the process for becoming eligible for disability benefits, and especially for retaining eligibility, does immeasurable harm to the public's trust in the social security program and in government as a whole.

The committee is also concerned about the increasing number and intensity of confrontations between the agency and the courts as SSA refuses to apply circuit court opinions. The Ninth Circuit court recently characterized the Secretary's defense of her non-acquiescence policy as "far from persuasive." The opinion goes on to state:

> . . . other circuits that have considered the question have already rejected the Secretary's argument that a Federal agency can legitimately ignore Federal appeals court precedents. See, e.g., Jones & Laughlin Steel Corp. v. Marshall, 636 F.2d 32, 33 (3d Cir. 1980); ITT World Communications v. FCC, 635 F.2d 32, 43 (2d Cir. 1980); Ithaca College v. NLRB, 623 F.2d 224, 228-29 (2d Cir.), cert. denied, 449 U.S. 975 (1980); Mary Thompson Hospital, Inc. v. NLRB, 621 F.2d 858, 864 (7th Cir. 1980); Allegheny General Hospital v. NLRB, 608 F.2d 965, 970 (3d Cir. 1979). Moreover, the cases cited by the Secretary to support her position appear to be inapposite. In short, our review of the relevant case law indicates that there is little chance that the Secretary will succeed in her argument that non-acquiescence is a legitimate policy, or, to put it more precisely, that she will persuade us that there is a strong probability that the plaintiffs would ultimately prevail on this fundamental issue.

While the issue of the constitutionality of the non-acquiscence policy may be in doubt, the undesirable consequences of escalating hostility between the Federal courts and the agency are clear. The committee sees no compelling reason why the Social Security Administration's interpretation of the statute, particularly in issues where the definitions are not specific or are completely silent on the issue, should be automatically considered superior to that of the Federal court.

SSA's reasons for the current policy appear to be based largely on the desire for consistent national administration of the program. It is also clear that Federal courts may frequently hand down decisions expanding agency policies in directions the agency and Congress may not wish applied on a national or regional basis. Since the guiding principle for Federal courts is the Constitution and the law, policy considerations such as cost constraints may play less of a role than they appropriately do in Congressional deliberations.

In such instances, however, the committee strongly believes that Congress' judgment as to the appropriate policy should prevail. If the Federal circuit courts hand down decisions that appear detrimental to the purposes or operation of the program, either the Supreme Court should be given the opportunity to make a determination that remedies the situation, or Congress may well have to clarify the law. In such cases, Congress might reasonably expect the agency to propose appropriate remedial legislation. Short of legislative changes, however, the committee sees no reason to allow SSA to ignore the law as determined in each circuit by the highest Federal court simply because the administrators view the Federal court's decision as mistaken.

Therefore, Section 910 of the bill requires the Social Security Administration to either apply the decisions of circuit courts of appeal to at least all beneficiaries residing within States within the circuit, or appeal the decision to the Supreme Court. This provision applies to circuit court opinions issued after the date of enactment as well as to those opinions which the Secretary still has the opportunity to appeal to the Supreme Court as of the date of enactment.

c. *Payment from trust funds for costs of rehabilitation services (sec. 911 of the bill)*

Prior to P.L. 97-35 (1981 Reconciliation Act), up to 1.5% of the total amount of disability benefits could be transferred from the trust funds for payment of vocational rehabilitation services for SSDI beneficiaries. In FY 1980 the amount transferred was $110 million (the amounts transferred generally were well below the 1.5% ceiling). An additional $50 million in general revenue funds were expended for SSI disability recipients. A benefit cost study completed by the Social Security Administration found that in 1975 between $1.39 and $2.72 savings accrued to the social security trust fund for every $1.00 spent in this program.

P.L. 96-265 (the 1980 Disability Amendments) included a provision that DI and SSI benefits could continue even after medical recovery until the individual completed a vocational rehabilitation program in which he was participating provided he had not been expected to recover when he entered the program and provided the program would increase the possibility of the individual permanently leaving the rolls.

P.L. 97-35 abolished the general DI trust fund program and further provided the State VR agencies could be reimbursed only for the costs of services to beneficiaries that result in the beneficiary's performance of SGA (substantial gainful activity) for a continuous period of at least 9 months. Trust fund expenditures for FY 1982 were about $2 million and have remained under $10 million each year since.

Section 911 provides assurance to vocational rehabilitation service providers that they will be reimbursed for services rendered to participants in the medical recovery program (Sec. 301 of P.L. 96-265) by removing the restriction added by P.L. 97-35 that reimbursement could occur only where the beneficiary had performed nine months of SGA and by adding a provision that reimbursement will occur where the beneficiary without good cause refuses to accept or fails to cooperate with services in such a way as to preclude successful rehabilitation.

The committee is concerned that provision of vocational rehabilitation services to social security beneficiaries be improved. Therefore, it directs the Advisory Council on Medical Aspects of Disability to examine the whole area of the availability of vocational rehabilitation services for social security disability beneficiaries with particular attention to the following issues: How to assure that beneficiaries are referred for services in the most expeditious manner; whether the Secretary should contract directly with public and private non-profit providers of services, including rehabilitation facilities; how to provide adequate incentives for State and non-profit organizations to participate in programs available to social security beneficiaries; and what types of services should be provided to people whose SSDI benefits are terminated as a result of a continuing disability investigation and how best to provide such services.

The committee also reaffirms the congressional intent that payment for eligible vocational rehabilitation services, based on reasonable estimates, be made to service providers in advance.

d. Advisory Council on Medical Aspects of Disability (sec. 912 of the bill)

At a time when several major aspects of the social security disability program are to be re-evaluated and potentially revised in the light of advances in medical and vocational diagnostic and therapeutic techniques, the committee believes it is desirable to assure that the Secretary has ready access to the advice and recommendations of medical and vocational professionals. Thus, the bill creates a temporary Advisory Council (which would expire on December 31, 1985) consisting of medical, psychological and vocational experts to provide the necessary advice and recommendations to the Secretary on disability standards, policies and procedures. To assure the input of appropriate professional and consumer organizations, the Council would be authorized to periodically convene a larger representative group and to set up temporary short-term task forces to examine particular specialized issues. Under the bill, the Council's recommendations to the Secretary would be communicated to the Congress in SSA's currently required annual report to the Congress on the status of the disability program.

Of most immediate concern to the committee is the participation of the Council in the required review of the mental impairment listings. The bill provides that the Council must be appointed within 60 days after enactment to assure the timely participation of the Council in this review.

The committee believes that the Council can also productively contribute to the reexamination of a number of other critical issues in the program. Section 912, for example, specifically directs the Council to examine and provide recommendations with respect to the question of requiring the involvement of appropriate medical specialists services; i.e., how best to assure their availability and effective delivery to disabled persons. Moreover, it is expected that the Council will participate in the assessment of possible policy changes affecting medical aspects of the program, particularly any changes that might be considered with respect to the evaluation of pain. Because the Advisory Council will be considering issues concerning the delivery of vocational rehabilitation services, work evaluation and appropriate procedures and criteria for such services and activities, it is expected that among those chosen to be included on the council will be those with expertise in administering State and private non-profit vocational rehabilitation programs.

e. Qualifying experience for appointment of certain staff attorneys to administrative law judge positions (sec. 913 of the bill)

To qualify for an ALJ appointment, one must be an attorney with at least seven years of experience participating in formal cases at regulatory agencies, or in the preparation and trial of cases in courts of record, or in certain other legal work described in announcement. At least two of those years must be in the field of administrative law or in certain activities regarding hearings or the trial of court cases. At least one year of qualifying experience must have been at the GS-14 level in the Federal service, or at a comparable level of difficulty and responsibility in other employment. The highest grade available for staff attorneys who assist social security ALJs is the GS-12 level. Social security ALJ appointments carry a lifetime tenure at a GS-15 level.

The committee shares the concerns repeatedly expressed by OPM and SSA about the difficulty of finding qualified candidates for social security ALJ positions. Staff attorneys who work with social security ALJs are readily familiar with the social security program and with adequate training represent a potential pool of candidates for ALJ positions.

Section 913 requires the Secretary to establish a sufficient number of attorney advisor positions at GS-13 or GS-14 levels to ensure adequate career advancement opportunity for attorneys employed by SSA, and to assign duties and responsibilities to enable individuals in these positions to achieve qualifying experience for an ALJ appointment. The committee notes that the Committee on Post Office and Civil Service has expressed support for this amendment.

4. SSI provision

a. Extension of the section 1619 program for the SSI disabled who perform substantial gainful activity despite severe medical impairment (sec. 926 of the bill)

Section 926 extends for two and one-half years, through June 30, 1986, the temporary authority contained in section 1619 of the Social Security Act that provides for the continuation of SSI benefits and/or Medicaid for disabled recipients who are able to work despite the continuation of their impairments.

Section 926 also requires the dissemination of information about the section 1619 program to the disabled and staff of various agencies and organizations.

Prior to mid 1985, HHS would compile information on the characteristics of section 1619 recipients including health services usage, impairments, and other information intended to be used in making recommendations regarding the continuation and/or needed modification in section 1619.

Section 1619 was enacted as part of the Disability Amendments of 1980 and was intended to lessen the work disincentives for SSI disabled recipients who, under prior law, risked the loss of SSI and Medicaid when they increase their work effort and earnings in spite of the continuation of their disability.

Section 1619(a) of the SSI law provides that an individual who loses eligibility for SSI because he or she works and demonstrates the ability to perform SGA, but who continues to have a disabling impairment, may become eligible for special SSI benefits until their countable income reaches the SSI income disregard "breakeven point". People who receive the special SSI benefits continue to be eligible for Medicaid on the same basis as regular SSI recipients.

Under section 1619(b), an individual can continue to be eligible for Medicaid even if their earnings have taken them past the SSI income disregard "breakeven point." This special eligibility status, under which the individual is considered a blind or disabled individual receiving SSI benefits for purposes of Medicaid eligibility, applies as long as the individual: (1) continues to be blind or have a disabling impairment; (2) except for earnings, continues to meet all the other requirements for SSI eligibility; (3) would be seriously inhibited from continuing to work by the termination of eligibility for Medicaid services; and (4) has earnings that are not sufficient to provide a reasonable equivalent of the benefits (SSI, State supplementary payments, and Medicaid) which would be available if he or she did not have those earnings.

Section 1619 was enacted to be effective for three years with the expectation that information would be gathered regarding the characteristics of those who benefit from section 1619 and the impact of such a program on reducing the work disincentives for the disabled under the SSI disability program. The most recent information available to the Committee from the Social Security Administration shows that in December 1982, 287 SSI recipients were receiving benefits under the provisions of Section 1619(a) and 5,600 former SSI recipients were retaining eligibility for Medicaid under section 1619(b). Approximately one-half of section 1916 recipients are under age 30 compared to only 16 percent of all SSI disabled adult recipients.

The Administration has agreed to an extension of section 1619 with the understanding that more complete data will be collected and available by mid 1985 for further evaluation of the program. The Administration has agreed to collect data regarding the characteristics of the individuals benefiting from these provisions, the effects on work effort, and, in the case of continued Medicaid coverage, the types of health care services utilized and their costs. Some of the specific areas that should be studied are (1) the types of impairments of the affected individuals, (2) the types of income available to these individuals: earned and unearned; the movement of individuals from one eligibility status to another; the kinds of health services used and the offsets to costs due to employer-related health insurance and other third-party resources. It is recognized that the collection and analysis of these data require the participation and cooperation of the Social Security Administration for matters involving eligibility, characteristics, and work incentives; the Health Care Financing Administration for matters relating to Medicaid costs and utilization; and the State agencies administering the Medicaid programs for providing Medicaid data in their files; and the Committee expects such cooperation.

This provision to continue the section 1619 program, also directs the Secretary of Health and Human Services and the Secretary of the Department of Education to develop and disseminate information and establish training programs for staff personnel, with respect to the potential availability of benefits and services for disabled individuals under the provisions of section 1619. At Committee hearings held in California and Washington, D.C. and from reports from the disabled and rehabilitation and social services agencies, the Committee found a lack of awareness or knowledge of the section 1619 program.

As stated in testimony at the hearings, "Getting information out to the disabled community is no simple task. It requires the best effort of the Social Security Administration and the cooperative efforts of disability organizations, rehabilitation agencies, and other groups concerned with disability." However, as was also stated in hearings by a disabled individual, who did not utilize the option available under section 1619 because the District office staff of the Social Security Administration did not inform her about section 1619. "In order for SSI recipients like me to use these work incentive options, we need to be aware of how they can help us attain our employment goals without jeopardizing our health and well-being."

The provision provides that the Social Security Administration would be responsible for training programs for their staff in the District offices. The Social Security Administration would also be responsible for making a concerted effort to inform SSI disability applicants and recipients about the provisions of Section 1619. The amendment also mandates that the Department of Education, intended to be carried out primarily through the Rehabilitation Services Administration to also be involved in getting information out to the State Vocational Rehabilitation agencies. In addition, working with and through such agencies, the information is also to be made available to the other public and private rehabilitation and social service agencies in the States and to the various organizations of and representing the disabled.

The section 1619 program is intended to be a tool which can be used by those agencies and organizations responsible for enabling the disabled to improve their capabilities to increase their level of self support, to live independently or to work in a sheltered environment. Therefore, the Subcommittee is concerned that unless there is a greatly increased effort to get information out to a broad range of individuals and organizations that many disabled individuals will not be made aware of this attempt by Congress to eliminate the work disincentives for those disabled who are able to work in spite of their impairment.

In a related matter, the Committee is concerned that the Administration is counting toward the "trial work period" any month in which the disabled is earning over $75 a month in a sheltered workshop. The Committee feels that the trial work period is to be used to, in effect, test the individuals ability to be eventually employed in regular competitive employment and therefore that employment in a sheltered work shop should not be counted toward the "trial work period" months.

At the hearing held by the Subcommittee on Public Assistance and Unemployment Compensation regarding the extension of the section 1619 program, the following case examples were presented as to the impact of the section 1619 program:

> In order for this committee to realize the impact of section 1619, a description of two cases should provide you with information that will, hopefully, assist in your decision. The first is a 26 year old woman who is a quadriplegic and requires an attendant to assist with her personal care and home care needs such as bathing, dressing, grooming, cooking, shopping and other needs. Vocational rehabilitation helped her complete a college program, providing funds for training and for attendant care. After graduating from college, she obtained full time employment as a computer operator with earnings of $650 a month. Although she briefly received attendant care under a State medical program, she eventually was told she must either quit working or lose her eligibility. Since she was unable to pay this herself, she decided to quit working.
>
> The second case is a personal friend on SSI who has overcome great barriers with his disability. He is a quadriplegic who has no use of his legs, right arm and limited mobility with his left arm. He obtained his Bachelor's degree in 1975 with assistance from the Vocational Rehabilitation Program. He then moved to Minnesota to continue with graduate school. Since no Medicaid Title 19 was available to assist with Attendant Care costs, he was forced into institutional care. In 1978, he was able to move out into the community of Minnesota due to the Attendant Care Program funded through the Federal and State Governments.

While finishing his education, he began full time work for a Rehabilitation Center, but after the nine month Trial Work Period, he would lose SSI status and, therefore, eligibility for Medicaid Title XIX and Social Services Title XX which paid for his Attendant Care. Ultimately, he had to quit an excellent position at the conclusion of his Trial Work Period or be forced to return to a life of dependency and institutional care. The cost of such care far exceeds the cost of continuing to live independently in the community with partial benefits.

Passage of the 1980 Social Security Disability Amendments, which included the provisions in Section 1619, changed the picture dramatically for these two individuals. In 1981, my friend was able to obtain employment at another Rehabilitation Center in Minneapolis. He has retained Medicaid Title XIX and Social Services Title XX, and receives some SSI payments which make it possible to pay the additional expenses of living independently.

Today, he holds a new position with a private non-profit consulting firm that provides technical assistance on disability awareness to corporations and businesses in the private sector. The firm sponsors seminars that show supervisors and management how to work and communicate with disabled employees, thus, creating increased employment opportunities for persons with disabilities.

If SSI Special Benefits Amendment (Section 1619) is not continued, he will again be forced to quit his job in order to avoid institutional care, since he cannot afford the cost of attendant services without public assistance while engaged in employment.

b. SSI disability program work evaluation and rehabilitation study

Section 927 would require the Advisory Council on the Medical Aspects of Disability to also study the following issues related to the SSI Disability program:

Consideration of alternative approaches to the use of work evaluation related to determination of eligibility for SSI disability benefit including: criteria for referral to work evaluation; relationship to rehabilitation potential and training; and appropriateness of providing stipends during extended work evaluation; and

Reexamining the definition of a successful rehabilitation of an SSI disabled recipient to include the ability of the severely disabled to work in a sheltered environment and live independently.

Work evaluation for purpose of the study would include determining an individual's: work activity capabilities; work activity limitations; rehabilitation potential; ability of the mentally impaired to cope with a competitive work environment; and needed modifications in the work setting to enable the individual to work.

Section 927 of the bill would require the Advisory Council on the Medical Aspects of Disability to consider alternative approaches to the use of work evaluation related to the SSI disability program. Such consideration by the Council should include examining proposals presented to the Committee on Ways and Means by various individuals and organizations with expertise in the area of work evaluation and rehabilitation.

The SSI program for the disabled grew out of the formerly State administered program for the disabled and was not an offshoot of the Social Security Disability Insurance program. Under the pre-SSI program the definition of disability was set by each State under some rather general Federal statutory and regulatory language.

While there is a common definition for disability for the Disability Insurance program and the SSI program, there are a number of very significant differences between the two programs and the characteristics of the recipients of disability insurance and SSI disability recipients. These differences are critical when evaluating an individual's potential for employment and when determining the approach which should be taken both in determining eligibility for disability benefits and the approach to rehabilitation activities for such recipients. In addition, it needs to be recoginized that Congress has defined a unique function for the SSI disability under the section 1619 program by providing ongoing income support and medical services under Medicaid for those disabled who have disabling impairments but who wish to have some level of employment in spite of their impairment.

The following chart compares some selected characteristics of the two programs and of the recipients of benefits under the two programs.

Comparison of Selected Characteristics of the SSI Disability Program and the Social Security Disability Program and a Comparison of Selected Characteristics of Recipients of Disability and SSI Disability Benefits

Social Security Disability Insurance	SSI Disability Insurance Program
A. Non-disability Basis for Eligibility	
A. Disability Insurance provides benefits for workers who are "insured for disability" and their dependents.	A. Eligibility for an the amount of SSI benefits for a disabled or blind individual is not related to whether the individual has earned social security coverage or to the level of an individual's previous earnings. Cash assistance for the disabled and blind under SSI is provided only to those in addition to meeting the disability criteria have income and resources low enough to meet the Federal plus state supplementation (if any) income eligibility standards. While approximately 34 percent of the disabled receiving SSI disability benefits also receive DI benefits, only one-third of those or 12 percent are DI recipients on the basis of their own work history.
B. Impact of Earnings by Recipients on Amounts of Benefits	
B. Earnings by DI recipients below the SGA earnings test level does not reduce the amount of DI benefits paid to the recipient.	B. SSI recipients have a $1 reduction in SSI benefits for every $2 in earnings in excess of $65 a month ($85 a month if no other income).
C. Major Disabling Diagnosis	
C. Approximately 12 percent of the DI recipients are eligible of the basis of mental impairments; circulatory disorders account for 29 percent of the disabling impairment; and skeletal-muscular impairments account for 19 percent.	C. Approximately 40 percent of the SSI disabled are eligible on the basis of mental impairments. Approximately 20 percent are on the basis of circulatory disorders.

COMPARISON OF SELECTED CHARACTERISTICS OF THE SSI DISABILITY PROGRAM AND THE SOCIAL SECURITY DISABILITY PROGRAM AND A COMPARISON OF SELECTED CHARACTERISTICS OF RECIPIENTS OF DISABILITY AND SSI DISABILITY BENEFITS—*Continued*

Social Security Disability Insurance	SSI Disability Insurance Program
D. Age of Recipients	
D. 7 percent are under age 30 and 66 percent of the DI population in ages 50 through 64 years of age.	D. 24 percent are under age 30 of the SSI disabled population ages 18-64 and 66 percent are ages 50-64 of the SSI disabled population ages 18-64.
E. Sex of Recipients	
E. 70 percent male and 30 percent female	E. 40 percent male and 60 percent female.

At the August 3rd hearing of the Subcommittee on Public Assistance and Unemployment Compensation, testimony was presented on behalf of the State of Michigan's Interagency Task Force on Disability by the Director of the Michigan Department of Mental Health. The Michigan Task Force, which consists of professional staff from the State Disability Determination Service, the State vocational rehabilitation service agency, the State department of Mental Health, Department of Social Services and other state agencies made recommendations based on a broad view of the role of Federal and state government's responsibilities as related to the disabled. In describing the proposed Michigan model, as to the recommended use to be made of work evaluation, the Task Froce representative contended that long term cost savings will accrue to the Federal government and to States through the use of work evaluations and vocational rehabilitation in selected cases.

The testimony stated that:

> The relationship between multiple impairments and work ability or the relationship between residual capacity and work ability should be reliably documented. This documentation should involve the application of accepted techniques by a trained conunselor who can become personally familiar with the claimant. This vocational documentation should become a part of the objective information which is reviewed in deciding whether disability benefits should be awarded. In this way, and only in this way, can ALJ's and disability examiners render uniform, reliable decisions based on objective assessments of a whole person—including equally-weighted medical and functional documentation.

In directing the Advisory council to consider alternative approaches to work evaluation, section 927 defines work evaluation as follows:

> For purposes of this section, "work evaluation" includes (with respect to any individual) a determination of (a) such individual's skills, (b) the work activities or types of work activity for which such individual's skills are insufficient or inadequate, (c) the work activities or types of work activity for which such individual might potentially be trained or rehabilitated, (d) the length of time for which such individual is capable of sustaining work (including, in the case of the mentally impaired, the ability to cope with the stress of competitive work), and (e) any modifications which may be necessary, in work activities for which such individual might be trained or rehabilitated, in order to enable him or her to perform such activities.

The reason that such an approach is recommended, especially as related to the SSI program is that most SSI applicants have had a very tenuous or non-existent connection to the work force. Therefore, if work evaluation is used only to determine eligibility for income assistance, the result could be to deny the individual the opportunity to gain access to those rehabilitation services which can enable an individual to lessen his or her dependency. On the other hand, if work evaluation is not used to accurately gauge, to the extent possible, the individual's limitations on being able to work at a substantially gainful wage level then the individual may be denied that financial assistance to which he or she is entitled and which is reflective of his or her very limited capacity to be self-sufficient.

This approach to work evaluation is illustrated in the following excerpt from the State of Michigan testimony:

> In the model, I propose all individuals who pass through the screening criteria would be determined "presumptively disabled" and would be granted SSI benefits for up to six months, during which time additional vocational information would be acquired. These presumptive beneficiaries would be referred to state Vocational Rehabilitation agencies for a work evaluation to determine their potential for either gainful employment or for the development of skills needed for successful sheltered employment.
>
> Results for work evaluations would be transmitted to examiners within the State DDS to be used in their final determinations of disability. If, based on comprehensive work evaluations, the claimant is found capable of SGA, the DDS would deny the individual as non-disabled. If the person is found to have no potential for SGA, and it is determined that further efforts at rehabilitation would not be effective (due to impairment), the case would be approved for SSI and SSDI benefits. In such cases, involvement in a sheltered workshop on an ongoing basis might be appropriate, with benefit levels reduced by the amount of sheltered workshop income. Finally, if the person is found to be potentially employable, SSI benefits would be granted during the person's progression (through rehabilitation) to more independent work settings. This latter possibility, involving training and rehabilitation, would vary

> in length depending on individual competencies. At all points in a work rehabilitation plan, disability benefits would be reduced by the amount of income earned, case management responsibility would be vested in the rehabilitation agency (with DDS diarying claimant progress).

The amendment suggests the evaluation of the concept of "stipends" to be provided to those in the work evaluation process. The purpose here is to recognize that those individuals with such borderline ability to be self supporting must have some means of subsistence level of income while in an extended work evaluation.

Section 927 also requires the Advisory Council to examine the criteria for assessing whether a recipient of SSI disability benefits will benefit from rehabilitation services. Specifically, the amendment provides that such an examination will consider whether such criteria should include not only whether an individual will be able to engage in substantial gainful activity but also whether such services can be expected to improve the individual's functioning so that he or she will be able to live independently or work in a sheltered environment.

Unlike the Disability Insurance program, earned income below the Substantial Gainful Activity earnings test of $300 a month received by SSI disability recipients does result in a savings to the SSI program. SSI benefits are reduced $1 for every $2 of earnings after the initial disregard of the first $85 a month for individuals with no other income. Therefore, rehabilitation services and training will have a savings to the SSI program even if the earnings of an SSI disability recipient does not reach the SGA earnings test of $300 a month.

In addition, at the income level provided under the SSI program even an additional small increment of income from sheltered employment can make a significant difference between marginal subsistence and some degree of independence, improved quality of life, and self-esteem which such earnings can provide.

C. SSI conforming amendments

Included in the bill as reported by the Committee are provisions to make generally the same changes in the SSI statute (Title XVI of the Social Security Act) as are made in the Disability Insurance program under Title II of the Social Security Act. The provisions also ensure applicability to the SSI Disability program of certain temporary provisions in Title IX affecting the Disability Insurance program. These include, for example, making applicable to the SSI program required studies related to pain and the moratorium in the reviews of the mentally impaired.

5. Effective date (sec. 914 of the bill)

Except as otherwise provided, these provisions of the bill would apply with respect to cases involving disability determinations pending in HHS or in court on or after the date of enactment.

TITLE X—MEDICARE BUDGET RECONCILIATION AMENDMENTS

A. Payment- and Coverage-Related Changes

1. Payment for outpatient diagnostic laboratory tests (sec. 1001 of the bill)

Present Law

Under present law, outpatient diagnostic laboratory services are reimbursed on the basis of reasonable charges when furnished by an independent laboratory or by a physician. Payment for such services to hospital outpatients is on the basis of reasonable cost. These laboratory services are covered under part B of the medicare program; thus, the beneficiary is subject to the part B deductible and coinsurance requirements.

Explanation of Provision

The bill would require the establishment of a fee schedule for all laboratory services except those for hospital inpatients. Payment would be based on the fee schedule unless the actual charge is lower. The schedule may initially be established on a carrier or regional basis; however, within three years after the date of enactment the Secretary would be required to develop and implement a national fee schedule.

The Secretary would be given the discretion to provide for adjustments to the national fee schedule to account for wage variations if the Secretary determines that variations in wages between different areas of the country significantly affect the cost of providing laboratory services and that an adjustment is appropriate.

The initial payment level for the fee schedule would be established at 60% of prevailing charges for the fee screen year beginning July 1, 1983. The Secretary would be required to adjust the fee schedules annually to reflect changes in the Consumer Price Index for all Urban Consumers (U.S. city average) and could make additional adjustments that the Secretary determines are justified by technological changes.

All clinical laboratories would be required to bill the medicare program directly, rather than billing the physician who ordered the tests (laboratories performing tests "under arrangement" with a hospital could continue to bill the hospital for hospital outpatients). Physicians would be permitted to bill for clinical laboratory services only if the physician (or another physician with whom the physician shares his practice) personally performed or supervised the performance of the test.

Independent laboratories would be required to accept medicare assignment. Hospital laboratories would have a similar obligation under the hospital's medicare participation agreement not to charge a hospital outpatient for whom the hospital's laboratory performs diagnostic tests. With respect to tests performed for nonhospital patients, the bill would require the hospital to accept assignment. Reimbursement for these assigned claims would be at 100% of the fee schedule and applicable deductible and coinsurance amounts would be waived.

Where a physician bills for laboratory services that he personally performs or supervises, the physician may accept or not accept medicare assignment on a claim by claim basis. When the physician agrees to accept assignment, medicare reimbursement would be at 100% of the fee schedule amount, and the coinsurance and any applicable deductible would not apply. When the physician chooses not to accept assignment, medicare reimbursement would be 80% of the fee schedule amount and applicable coinsurance and deductible amounts would apply.

The bill provides for the payment of a nominal fee for the drawing of patient specimens. However, this payment may be made only once per encounter to either the physician or the clinical lab, whomever draws the specimen. The committee intends that the Secretary would determine an appropriate payment amount for these services. The payment may vary under specified circumstances if the Secretary determines differences in costs make such an adjustment appropriate.

Current law authorizes the Secretary, for certain items and services, to establish medicare reasonable charge levels at the lowest charge levels at which the item or service is widely and consistently available in a locality. The committee believes that these provisions of law would no longer be applicable with respect to clinical laboratory services once the fee schedule reimbursement system is implemented.

The Secretary would be directed to simplify current billing requirements for laboratory services. Such simplication may include eliminating requirements that a patient diagnosis appear on a clinical laboratory bill, mechanisms to ensure prompt payment, minimizing the amount of information required for claims processing and facilitating bulk or periodic billing for multiple beneficiaries.

Effective Date

The provision would be effective for services furnished on or after March 1, 1984.

2. Continue existing part B premium calculations (sec. 1002 of the bill)

Present Law

By law, the Secretary of Health and Human Services is required to calculate and announce each September the amount of the monthly premiums that will be charged in the following calendar year for people enrolled in the Supplementary Medical Insurance (part B) portion of the medicare program.

A temporary provision of law requires that the premium amount be calculated so as to produce premium income equal to 25 percent of program costs for enrollees aged 65 and over. (The same premium amount is charged beneficiaries below age 65 who have medicare entitlement by virtue of being disability or end-stage renal diseases patient beneficiaries.) This temporary provision is in effect only for 1984 and 1985 premiums.

Beginning with 1986, the premium calculation will revert to an earlier method under which the premium amount is the lower of: (1) an amount sufficient to cover one-half of program costs for the aged; or (2) the current premium amount increased by the percentage by which cash benefits were most recently increased under the cost-of-living adjustment (COLA) provisions of the social security program. Under this formula, premium income, which originally financed half of program costs for the aged, declined to less than 25 percent of program costs.

Explanation of Provision

The bill would make permanent the existing temporary provision which fixes the proportion of the part B medicare costs financed by enrollees at 25 percent of program costs. This would extend current law beginning January 1, 1986.

Effective Date

The provision would apply to premiums for months beginning with January 1986.

3. Coverage of administration of hepatitis B vaccine (sec. 1003 of the bill and sec. 1861 of the Act)

Present Law

Current law prohibits medicare coverage of immunizations and vaccines except in the case of pneumoccocal vaccine, which the Congress specifically covered in 1980.

Explanation of Provision

The bill would provide medicare coverage of hepatitis B vaccine for medicare beneficiaries when the vaccine is administered in a hospital or renal dialysis facility. The applicable medicare part B deductible and coinsurance is waived.

The committee intends that the Secretary limit those eligible to receive the hepatitis B vaccinations to those at high risk of infection. The committee anticipates that the Secretary will develop coverage guidelines using available information to define those groups at high risk of contracting this disease, using specifically, but not necessarily exclusively, the information developed by the Centers for Disease Control (CDC).

The committee understands that one of the groups at high risk, identified by the CDC, is the medicare end-stage renal disease population. Medicare beneficiaries suffering from end-stage renal disease are particularly susceptible to hepatitis B and are currently monitored by testing, frequently on a monthly basis, for the virus. The committee believes that this population should be covered by this provision.

The committee has given the Secretary the flexibility to develop a payment method that may be different from the usual medicare reimbursement rules. In developing such a payment system, however, the committee believes that it should be entirely separate from the composite rate reimbursement system for renal dialysis services. Furthermore, the committee believes that any payment system should provide a payment amount which reasonably reflects the cost of efficiently providing and administering the vaccine.

Effective Date

The provision would be effective for services furnished on or after January 1, 1984.

4. Pacemaker reimbursement review and reform (sec. 1004 of the bill)

Present Law

Under present law, the costs of inpatient hospital services with respect to the implantation of pacemakers, including the costs of the device, are subject to the new diagnosis-related group (DRG) prospective payment system. However, the costs of physicians' services for implantation and post-implantation monitoring of the devices are reimbursed under part B and are not subject to the new system.

Explanation of Provision

It is anticipated that the new DRG prospective payment system will significantly reduce the costs of hospital inpatient services with respect to pacemaker implantation. However, concerns remain with regard to the frequency of subsequent monitoring, physicians' fees, and warranties with respect to the devices.

Concerns have been raised with respect to the frequency of transtelephonic monitoring of implanted pacemakers. The bill would require the Secretary of Health and Human Services to issue, before February 1, 1984, revisions to the current guidelines on the frequency of transtelephonic monitoring procedures which are reasonable and necessary. It is anticipated that the Secretary will have had time to review a number of analyses which are currently being conducted on this subject before that date.

The bill provides that, if the Secretary has failed to issue such revised guidelines before February 1, 1984, payments under medicare will be limited to those specified in the legislation. The bill limits the frequency of monitoring procedures to no more than: (1) weekly during the first month of implantation, (2) once every two months during the period representing 80 percent of the estimated life of the device, and (3) monthly thereafter. The Committee wishes to make it clear that the application of these restrictions would be limited to single-chamber cardiac pacemakers powered by lithium batteries. In addition, the bill provides that the limitations would not apply where special medical factors (including possible evidence of pacemaker malfunction) justify more frequent monitoring.

The bill requires the Secretary to report to the Congress on the appropriateness of the current rate of physician reimbursement for services associated with implantation and replacement of pacemakers and pacemaker leads. The Secretary would be required to take into account the amounts recognized as reasonable with respect to the procedures and the time and difficulty of the procedures compared to those when such rates were first established. The Committee intends that the Secretary shall take into consideration improvements in efficiency of pacemaker implants in reviewing the appropriateness of payments to physicians. In making such a report, the Secretary would be required to take into consideration the reduction of such recognized rates by 20 percent. The report would be due on April 1, 1984.

Finally, the bill would require the Secretary, through the Food and Drug Administration, to provide a registry of all cardiac pacemaker devices and leads for which payment may be made under medicare. The registry would include the manufacturer, model, serial number, and manufacturer's price, the name of the recipient, the date and geographic location of the implantation or removal, and the name of the physician, hospital or other provider. The registry would be required to include any express or implied warranties associated with the device and any other information which the Secretary deemed appropriate.

The purpose of the registry would be to assist the Secretary in determining when medicare payments may properly be made, in determining when inspection by the FDA may be necessary for purposes of review and testing for malfunctions of pacemakers, and in carrying out such other studies as the Secretary may determine appropriate. The Secretary would be specifically prohibited from identifying any recipient of a pacemaker by name.

In any case where the Secretary had reason to believe that replacement of a pacemaker was related to its malfunction, the Secretary would be permitted to require the testing of such device by the FDA or be present at the testing by the manufacturer.

Effective Date

The provision would be effective upon enactment.

5. Payment for debridement of mycotic toenails (sec. 1005 of the bill)

Present Law

Routine foot care is not covered under the medicare program; however, medicare does allow reimbursement to physicians for debridement of mycotic toenails (toenails with a fungal infection) which cannot be performed by a nonprofessional.

There has been considerable concern regarding the frequency with which this procedure is taking place. The Health and Human Services Inspector General conducted a review in Virginia and concluded that this benefit was was being abused, because the procedure was being performed more frequently than necessary and was being performed on patients (particularly nursing home patients) who did not require professional care.

Explanation of Provision

The bill would require the Secretary, by regulation, to deny coverage under the medicare program for debridement of mycotic toenails if performed more frequently than once every 60 days. Exceptions would be authorized if medical necessity were documented by the physician.

It is the intent of the provision to assure that payment will not be made for debridement performed more frequently than every 60 days; however, the committee is aware that the Secretary may wish to evaluate the practice further and may determine that a tighter standard is more appropriate. It is not the intent of this provision to prohibit the Secretary from establishing a standard which is more restrictive than that provided in the statute. The Secretary would not be prohibited from establishing a rule limiting payment to debridement performed less frequently than every 60 days (except as medically necessary).

Effective Date

The provision would be effective upon enactment.

6. Payments for costs of hospital-based mobile intensive care units (sec. 1006 of the bill)

Present Law

In general, ambulance services are reimbursed under medicare on a reasonable charge basis; if they are furnished by a hospital, they are reimbursed on a reasonable cost basis. However, such services are covered only if the patient is transported to the hospital or to another specified location. In addition, the patient is responsible for a coinsurance payment of 20 percent.

Mobile intensive care units (MICU's) are vehicles equipped with sophisitcated advanced life support systems and staffed by paramedics trained to deal with life threatening emergencies. They also have portable telemetry equipment that allows them to remain in constant communication with a physician.

Several hospitals in New Jersey operate MICUs. They provide on-the-scene services but they do no transport the patient to the hospital. Rather, they operate in conjunction with community volunteer emergency vehicles which transport the patient to the hospital for no charge.

The State of New Jersey currently has a medicare waiver under which it operates a prospective payment system. To receive the waiver, the State was required to provide assurances to the Secretary of HHS that expenditures for medicare under the system would not exceed those which otherwise have been made.

Explanation of Provision

The bill provides that medicare would make payment to hospitals under part A for the operation of mobile intensive care units if certain conditions are met. The hospital must be located in a State which has a Statewide prospective payment system approved by HHS either under a demonstration waiver or under the new section 1886(c) programmatic waiver. Where the State has a demonstration waiver, the provision will apply unless the State notifies the Secretary of HHS within 30 days of the date of enactment of this bill that the State does not want the provision to apply. In the case of a section 1886(c) waiver, the State must notify the Secretary within such reasonable period as the Secretary may establish.

Finally, the State must provide satisfactory assurances that total medicare and medicaid payments to the hospitals covered under the State system will not exceed the total payments which would have been made. The committee intends that this provision be applied only under very limited circumstances. The case of New Jersey provides a special situation in which volunteer ambulances transport patients to hospitals. It is not the desire of the Congress through the medicare program to disrupt this community service. However, the committee anticipates that in most cases, medicare payments for ambulance and intensive care services will continue to be made subject to the same conditions and limitations as under present law.

Effective Date

The provision would be effective retroactivity to January 1, 1983.

7. Payment for physicians' services furnished to hospital inpatients (sec. 1007 of the bill)

Present Law

Under current law, medicare pays for physician services on the basis of medicare-determined "reasonable charges". Reasonable charges are the lesser of: (1) a physician's billed charge; (2) the customary charge made by an individual physician for a specific service; and (3) the prevailing level of charges made by all physicians for specific services in a geographic area. The customary and prevailing charges are updated annually (on July 1) to reflect changes in physician charging practices. Increases in the prevailing charge levels are limited by an economic index, which reflects changes in the physicians' practice costs and changes in general earnings levels.

Under current law, the medicare program provides for two alternative ways of paying for services provided to medicare beneficiaries: (1) the physician can bill the medicare beneficiary his usual fee, just as he would most other patients. The beneficiary is then responsible for obtaining the reimbursement from the medicare carrier. The beneficiary is responsible for the deductible amount (if not previously satisfied), the 20% coinsurance on the medicare-allowed charge, plus 100% of the physician's fee above the allowed charge. (2) The beneficiary may choose to assign his rights to payment to the physician who may agree to accept assignment. Under the "assignment of benefits" option, the physician agrees to accept the medicare determined reasonable charge as payment in full and is paid directly by the medicare carrier. The physician may bill the beneficiary only for the 20% coinsurance and any applicable deductible.

The medicare program currently allows physicians to decide whether or not to accept medicare assignment on a case-by-case basis. There has been a significant decline in physician willingness to accept assignment over the last 15 years, although in the last 2-3 years there has been a slight increase. Recent data indicate that approximately 53% of medicare claims are assigned, amounting to 54% of charges.

Explanation of Provision

The bill as reported provides for a six-month freeze on the economic index used to limit prevailing charges. The freeze would be applicable only to charges for physician services provided to hospital inpatients and, beginning January 1, 1984, would return prevailing charge levels to those that were in effect prior to July 1, 1983. The levels would be frozen until July 1, 1984, and there would be no provision for a catch-up in subsequent years.

Physicians would be required to accept medicare assignment for all services provided to medicare hospital inpatients. This mandatory assignment provision would remain in effect until six months after the Congress receives the Secretary's report and recommendation on the advisability and feasibility of including payments for inpatient physician services in the DRG prospective payment legislation. Under the bill, the report is due on July 1, 1985.

The medicare provider agreement that all hospitals receiving medicare reimbursement are required to have would be modified. The new provider agreement would obligate the hospital to obtain signed agreements from each doctor on its medical staff (courtesy or otherwise) who provides inpatient services in the hospital stating that the physician agrees to accept assignment for any medicare beneficiary that he treats as an inpatient of that hospital. The committee expects that the Secretary will specify the form and manner in which hospitals will be required to satisfy this requirement.

Although the hospital would be required to obtain the assignment agreement from the each physician providing services to inpatients of the hospital, the hospital would not be responsible for enforcing the assignment agreement. The current law provisions relating to physicians who fail to honor their assignment agreement would apply and enforcement would be through the usual administrative and judicial channels, except that the hospital would be expected to notify appropriate authorities if it became aware that a physician had failed to honor his assignment agreement.

The committee's reported bill includes the mandatory assignment requirement because of concern over the possibility of that in its absence beneficiaries would end up bearing at least some part of the burden of the cost saving for the medicare program resulting from the prevailing fee freeze. The requirement that hospitals obtain assignment agreements from their medical staffs was include to assure that no beneficiary would be left with the responsibility for the entire bill of a physician who refused to accept assignment after agreeing to treat a medicare patient.

Although physicians have had the option, since the beginning of medicare, of deciding on a case by case basis whether to accept or refuse medicare assignment, there is ample precedent for an arrangement under which medicare program payment is required to be treated as payment in full (except for deductible and coinsurance amounts). This is the basis on which about three-fourths of medicare payments are made today and have been made since the program began.

Hospitals and other providers of services have always operated under a medicare participation agreement which obligates them not to impose additional charges on the beneficiary. In the interest of protecting the beneficiary against increased out of pocket expense, the committee's reported bill adopts a similar approach with respect to inpatient physician services only. This provision would be in effect for a temporary period only. At the conclusion of tht period, the Congress will have available to it the Secretary's report and recommendations mentioned above, as a basis for its consideration of future payment arrangements for physicians' services to hospital inpatients.

Effective Date

The provision would be effective for services furnished on or after January 1, 1984.

B. Miscellaneous Administrative Changes

1. Presidential appointment of and pay level for the administrator of the Health Care Financing Administration (sec. 1021 of the bill and sec. 1117 of the Act)

Present Law

By law, the Administrator of the Health Care Financing Administration (HCFA) is in the Senior Executive Service and is appointed by the Secretary of the Department of Health and Human Services.

Explanation of Provision

The bill provides for the appointment of the Administrator of HCFA by the President with the advice and consent of the Senate. The position and pay of the Administrator would be increased to Level IV of the Executive Schedule.

Effective Date

The provision would be effective with respect to appointments to the position made after enactment.

2. Permitting limited provider representation on peer review organizations (sec. 1022 of the bill and sec. 1153 of the Act)

Present Law

Under current law, no health care facility such as a hospital may be a peer review organization (except by specific rules of delegated review). The law specifically prohibits the Secretary of HHS from contracting with an entity which is, or is affiliated with (through management, ownership or common control), a health care facility. The Secretary, by regulation, has interpreted this to mean that a peer review organization (PRO) may not have a governing body which has a member or individual who is a governing body member, officer, or managing employee of a health care facility.

Explanation of Provision

It is common among professional standards review organizations (PSRO's) (which are being phased out and replaced by PRO's) for one or two of the hospital administrators to sit on the PSRO board. The regulation could have the effect of prohibiting any physician or other person who is on the board of, or has certain administrative responsibilities in, a hospital from serving on the board of a PRO.

The bill provides for limited representation of providers on PRO's. In the case of a PRO with a governing body of 15 or fewer members, one such member may be a governing body member, officer, or managing employee of a health care facility; and in the case of a PRO with a governing body of more than 15 members, no more than two such members may be a governing body member, officer, or managing employee of a health care facility.

Effective Date

The provision would take effect upon enactment.

3. Access to home health services (sec. 1023 of the bill and secs. 1814 and 1835 of the Act)

Present Law

(a) Current law requires a physician to certify as to a patient's health needs and establish a plan-of-care before the beneficiary can qualify for home health benefits. The Secretary is directed, however, to prescribe regulations to disqualify physicians from carrying out these functions for patients of any agency in which they have a significant ownership interest or a significant financial or contractual relationship.

(b) Current regulations, specifying which physicians are disqualified from carrying out the certification and plan-of-care functions for patients of a home health agency, include physicians who are uncompensated officers or directors of incorporated agencies, even though they have no financial interest in its operation.

Explanation of Provision

(a) The bill would permit a physician who has financial interest in an agency which is a sole community home health agency to carry out the certification and plan-of-care functions for patients who will receive services from the agency. Existing regulations, which were intended to prevent potential conflicts of interest, have created a serious problem for the relatively few patients whose physicians have an interest in the only agency in the area. These patients have been unable to qualify for home health benefits unless they changed physicians.

The Secretary would be required to promulgate regulations defining "sole community home health agencies" for purposes of this provision.

(b) The bill would delete from the list of disqualified physicians uncompensated officers or directors of incorporated agencies. These physicians do not stand to gain or lose from referrals to the agency.

Effective Date

(a) The provision would be effective upon enactment.

(b) The provision would be effective for certifications and plans established or reviewed on or after the date of enactment.

4. Repeal of special tuberculosis treatment requirements (sec. 1024 of the bill and secs. 1814 and 1866 of the Act)

Present Law

Present law contains a number of provisions intended to assure that institutional services provided to medicare and medicaid patients suffering from tuberculosis are not custodial in nature and that such treatment can reasonably be expected to improve the patient's condition or render the condition noncommunicable.

Explanation of Provision

The bill repeals the special provisions. Advances in the active treatment of tuberculosis make such safeguards against paying for custodial care for tuberculosis patients unnecessary. The bill also eliminates the special provider category in present law for tuberculosis hospitals in the medicare and medicaid programs.

Effective Date

The provisions would take effect upon enactment.

5. Indirect payment of supplementary medical insurance benefits (sec. 1025 of the bill and sec. 1842 of the Act)

Present Law

Current law does not, in general, permit payments to be made to anyone other than a beneficiary or an entity providing services.

Explanation of Provision

The bill would permit part B payments to be made to a health benefits plan, if the beneficiary agrees, and if the physician or other supplier accepts the plan's payment as payment in full.

Effective Date

The provision would take effect upon enactment.

6. Including podiatrists in definition of "physician" for outpatient physical therapy services and including podiatrists and dentists in definition of "physician" for outpatient ambulatory surgery (sec. 1026 of the bill and secs. 1861 and 1832 of the Act)

Present Law

(a) The services of a podiatrist (when acting within the scope of his practice under State law) are covered under the existing medicare program; also, a podiatrist is generally defined as a "physician" for certain physician certification purposes. However, a podiatrist is not a "physician" for purposes of the outpatient physical therapy benefit under medicare. Outpatient physical therapy services are overed only if the patient is "under the care of a physician." For this purpose the law defines a physician as an M.D. or D.O. (excluding podiatrists).

A podiatrist (acting within the scope of his practice) is a "physician" for certifying the need for care, including the need for services such as physical therapy in the provider setting but is not a "physician" for purposes of outpatient physical therapy.

(b) A dentist is a "physician" for covered dental services. However, for outpatient ambulatory surgery in a surgeon's office, medicare does not define either a podiatrist or a dentist as a "physician."

Medicare provides coverage under preferential terms for certain outpatient ambulatry surgery (a) in an ambulatory surgical center, and (b) in a surgeon's office. Podiatrists and dentists are physicians for purposes of surgery in an ambulatory surgical center. (Certain dental surgery is covered despite the general exclusion of dental care.)

Certain technical problems have prevented issuance of regulations under which surgery in a surgeon's office could be covered. If the provision were to be implemented, services of both dentists and podiatrists would be excluded because they are not defined as "physicians" for this purpose.

Explanation of Provision

(a) The bill would define a podiatrist (when acting within the scope of his practice) as a "physician" for purposes of the requirement that an outpatient physical therapy patient must be under the care of a physician.

(b) The bill wuld include dentists and podiatrists among the "physicians" whose services are covered under the provisions relating to ambulatory surgery in a surgeon's office.

Effective Date

The provision would be effective for services furnished on or after the date of enactment.

7. Establishment by physical therapists of plans for physical therapy (sec. 1027 of the bill and sec. 1861 of the Act)

Present Law

Under current law, medicare payment for outpatient physical therapy services furnished to a beneficiary may be made only if a plan for furnishing such services has been established by a physician and is reviewed periodically by the physician.

In actual practice, physicians frequently rely on the physical therapists to recommend a plan of treatment for physical therapy services. However, the physician actually prescribes the services for a patient and routinely signs and reviews the plan of treatment recommended by the physical therapist.

Explanation of Provision

The bill would allow either the physical therapist or the physician to establish the plan of treatment. The physician would still be required to periodically review the plan as under existing law. This would make the establishment and review of the plan of treatment for physical therapy the same as that permitted under the existing medicare speech therapy benefit.

Effective Date

The provision would be effective with respect to plans of care established on or after the date of enactment.

8. Access to records of subcontractors (sec. 1028 of the bill and sec. 1861 of the Act)

Present Law

Under P.L. 96-499 (The Omnibus Reconciliation Act of 1980), in any agreement between a medicare provider and a subcontractor valued at $10,000 or more, the Secretary or Comptroller General must have access to the subcontractors' records.

Explanation of Provision

The bill increases the amount to a $50,000 minimum, thus alleviating a paperwork burden for small contractors.

Effective Date

The provision would be effective with respect to contracts entered into with subcontractors on or after date of enactment.

9. Medicare recovery against certain third parties (sec. 1029 of the bill and sec. 1862 of the Act)

Present Law

Under the current law, the medicare program may make benefit payments for services or which other third part insurance programs (e.g., worker's compensation, auto or liability insurance, and employer health plans) are ultimately liable for some or all of the costs. However, the Secretary does not now have the right of subrogation, to become a party to claims against other liable parties or to recover directly from such parties.

Explanation of Provision

The bill establishes the statutory right of medicare to recover directly from a liable third party, if the beneficiary himself does not do so, and to pay a beneficiary, or on the beneficiary's behalf, pending recovery where such third party is not expected to pay promptly. The bill would also permit the Secretary to recover directly from the third party whether or not the beneficiary brings suit to recover and subrogate to the United States the right of the individual or anyone else to payment from the third party. These provisions are intended to improve the ability of the medicare program to obtain reimbursement to which it is entitled by law. The bill would not permit medicare to bring an action against a beneficiary who had already been paid by the third party. Rather, the normal medicare rules with respect to collection of overpayments would apply.

10. Use of accrediting organizations for certain entities furnishing services (sec. 1030 of the bill and sec. 1865 of the Act)

Present Law

Under current law, the Secretary has authority to reply on certain accrediting organizations in determining whether hospitals, skilled nursing facilities, home health agencies, ambulatory surgical centers and hospice programs meet medicare requirements.

Explanation of Provision

The bill extends the Secretary's authority to permit the Secretary to rely on such organization's in determining whether rural health clinics, laboratories, clinics, rehabilitation agencies, including outpatient rehabilitation facilities, and public health agencies meet medicare requirements (and clarify the Secretary's authority with respect to ambulatory surgical centers). The committee believes that the standards of an accrediting organization should be at least equivalent to those of the Secretary, and such organization should have a satisfactory record of application of such standards.

Effective Date

The provision would take effect upon enactment.

11. Confidentiality of accreditation surveys (sec. 1031 of the bill and sec. 1865 of the Act)

Present Law

Current law contains certain disclosure safeguards relating to survey information used by the Secretary in connection with the hospital certification process under medicare. However, the law only specifically refers to surveys conducted by the Joint Commission on the Accreditation of Hospitals (JCAH).

Explanation of Provision

The bill extends the same disclosure protections given JCAH survey information to similar survey information provided to the Secretary by the American Osteopathic Association or other national accreditation organizations.

Effective Date

The provision would take effect upon enactment.

12. Thirty-day coverage for services furnished by a home health agency whose agreement has been terminated (sec. 1032 of the bill and sec. 1866 of the Act)

Present Law

Under current law, if medicare participation of a home health agency is terminated, the Secretary is required to continue to pay for services provided to a beneficiary until the end of the calendar year in which the termination took place. This requirement is only applicable to services provided under an individual plan of care established prior to the termination of the agency.

Explanation of Provision

The bill changes from the end of the calendar year to 30 days after termination, the ending of coverage for services provided under a plan established prior to the termination date of the participation agreement. The bill brings provisions for home health agencies into conformity with provisions for hospitals and skilled nursing facilities.

Effective Date

The provision would apply with respect to terminations whose effective date falls after 60 days after the date of enactment.

13. Termination of agreements with institutions and entities where owners or certain other individuals have been convicted of certain offenses (sec. 1033 of the bill and sec. 1866 of the Act)

Present Law

Current law authorizes the Secretary to bar from participation in medicare (and to direct State agencies to bar from medicaid) a person convicted of program-related criminal offenses.

Explanation of Provision

The bill extends the Secretary's authority to exclude from medicare participation (and to direct State agencies to exclude from medicaid participation) any entity in which ownership or controlling interest is held by a person convicted of program related criminal offenses, or in which an officer, director, agent or managing employee was convicted of such criminal offense.

Effective Date

The provision would take effect upon enactment.

14. Elimination of Health Insurance Benefits Advisory Council (sec. 1034 of the bill and sec. 1867 of the Act)

Present Law

Section 1867 of Social Security Act provides for a 19 member panel of health experts (the Health Benefits Advisory Council or HIBAC) appointed by the Secretary to advise on matters of general policy with respect to the medicare program.

Explanation of Provision

The bill repeals Section 1867 of the Social Security Act. HIBAC was very active in the early years of the medicare program when regulations were first promulgated. As the Federal Govenment gained experience in administering the medicare program, the Council's advisory functions with respect to regulations became less important. With passage of the Social Security Amendments of

1972, Public Law 92-603, the Council's authority to review regulations and recommend changes was specifically deleted, and its role limited to advice on matters of "general policy." Also, its purview was extended to include the medicaid program. However, HIBAC has not been called upon to advise the Secretary since late in 1976, and there are currently no members.

Effective Date

The provision would take effect upon enactment.

15. Open enrollment periods for health maintenance organizations and competitive medical plans (sec. 1035 of the bill and sec. 1876 of the Act)

Present Law

Health maintenance organizations (HMO's) are required to have an open enrollment period of at least 30 days during which time they must accept medicare beneficiaries up to the limits of their capacity.

Explanation of Provision

The bill requires the Secretary to designate one 30-day period in which all of the HMO's in an area participating in medicare must have an open enrollment period. The HMO would be permitted, in addition, to conduct open enrollment at other times during the year or hold enrollment open throughout the year. The Secretary would be required to establish annual per capita rates in a manner that assures that the beneficiaries enrolling during the designated 30-day open enrollment period will not have their premiums changed or their benefits decreased for the 12 month enrollment period for which the beneficiary is enrolling.

The Secretary, in establishing the open enrollment period for an area, would be directed to consult with HMO's in a geographic area concerning the timing of the annual 30-day open enrollment period.

The committee understands that there may be some difficulty in administering this provision and has therefore allowed the Secretary to spend a period of not more than three years to phase in this provision. The committee intends that the Secretary make every effort to designate open enrollment periods for different areas as soon as possible and not wait until the second or third year of this period before designating open enrollment periods.

Effective Date

The provision would take effect upon enactment.

16. Deadline for report on including payment for physicians' services to hospital inpatients in DRG payment amounts (sec. 1036 of the bill)

Present Law

The Social Security Amendments of 1983 (P.L. 98-21) required the Secretary of Health and Human Services to report to the Congress recommendations on the advisability and feasibility of making payments for physician services furnished to hospital inpatients based on a diagnosis-related group system and to make legislative recommendations. The report was to be part of the report made to the Congress during 1985.

Explanation of Provision

The bill would specify that the Secretary is to report to the Congress by July 1, 1985. This would establish a date certain for the report and would give the Congress additional time to act on the recommendations contained in the report.

Effective Date

The provision would become effective upon enactment.

17. Flexible sanctions for noncompliance with requirements for end-stage renal disease facilities (sec. 1037 of bill and sec. 1881 of the Act)

Present Law

Current law and regulations provide for decertification of end-stage renal disease (ESRD) facilities that are not in complete compliance with medicare program requirements.

Explanation of Provision

The bill allows the Secretary to apply intermediate sanctions, such as a graduated reduction of or denial of a portion of, reimbursement to ESRD facilities, when noncompliance does not jeopardize patient health or safety or justify decertification of such facilities. Noncompliance would, in these cases, mean noncompliance primarily with administrative requirements. The bill would make the sanctions imposed on ESRD facilities comparable to those of nursing homes which are out of compliance.

Effective Date

The provision would take effect upon enactment.

18. Removing costs of nurse anesthetists from DRG-based payments (sec. 1038 of the bill and sec. 1886 of the Act)

Present Law

Under the new prospective payment system enacted as a part of the Social Security Amendments of 1983 (P.L. 98-2), medicare's payments to hospitals under part A will be based on the diagnosis of the patient. Each diagnosis-related group (DRG) payment is intended to cover all the services that hospitals customarily furnish in caring for patients with a specified diagnosis.

Certified registered nurse anesthetists (CRNA's) have a variety of employment arrangements. Nearly 40 percent of all anesthesia services are provided by CRNA's employed by, or under contract with, hospitals. Physicians who provide anesthesia can bill the medicare program directly under part B. These physicians may also employ nurse anesthetists and bill for their services through part B.

P.L. 98-21 provided that all non-physician services provided to hospital inpatients could only be paid for under part A. This would mean that the services of a CRNA employed by physician and currently billed under part B would have to have been billed under part A. Because such a result might disrupt the present employment relationship of CRNA's, the Department of Health and Human Services (HHS) in its regulations of September 1, 1983 established a temporary provision to provide for a transition with respect to the payment for the services of CRNA's billed under part B.

The regulations provide that, if a physician employed nurse anesthetists during a designated period prior to implementation of prospective payment, then that physician may continue to employ CRNAs through cost reporting periods beginning before October 1, 1986.

Explanation of Provision

Despite the effort by the Department of HHS to stabilize the employment circumstances of CRNAs under part B, there remains an incentive for hospitals who currently employ, or contract with, CRNAs to substitute the services of anesthesiologists. The provision in the committee bill is intended to eliminate that incentive. It would apply for the same transition period provided with respect to the services of CRNAs under part B.

The bill would remove from the definition of "operating costs of inpatient hospital services," for purposes of the application of the new prospective payment system, costs related to employment of, or contracts for professional services of, certified registered nurse anesthetists. This would mean that hospitals would continue to be reimbursed for the services of such nurse anesthetists on a cost basis. The committee intends, however, that such costs would be subject to such limits as the Secretary may wish to establish.

The committee intends that the provision would be budget neutral for those years in which budget neutrality applies. The committee believes that it would be appropriate for the Department of HHS to reduce the aggregate DRG payments for all hospitals by an amount which represents the costs of CRNAs currently employed by hospitals in order to avoid hospitals receiving duplicate payments for such services.

HHS may also wish to reduce the hospital specific portion (HSP) of a hospital's payment by an amount which reflects the employment of CRNAs. The committee realizes that such adjustments may result in an administrative burden on the Department and, therefore, leaves the appropriate implementation of the adjustments necessary to achieve budget neutrality and avoid duplicate payments to the discretion of HHS.

The Secretary has been required by P.L. 98-21 to report to the Congress on recommendations on the advisability and feasibility of providing for DRG-type payments for physicians' services furnished to hospital inpatients. The bill would require the Secretary to include in that report legislative recommendations on compensation for CRNA's under the DRG system. The committee suggests that the Secretary also look at the advisabiity of making payments directly to CRNA's.

Effective Date

The provision would be effective with respect to cost reporting periods beginning on or after October 1, 1983 and before October 1, 1986.

19. Determination of hospital area wage index (sec. 1039 of the bill and sec. 1886 of the Act)

Present Law

Under the prospective payment system, the payments made to hospitals are adjusted to reflect differences in area hospital wage levels. The adjustment is an index or ratio based on the average hospital wage level in the geographic area compared to the national average. The index is calculated based on wage and employment data maintained by the Bureau of Labor Statistics (BLS) of the Department of Labor. The data is currently the most reliable national data available. Wage indexes are published for each Metropolitan Statistical Area (MSA)—the successors to SMSA's—and for each rural area as well as for urban and rural areas under classifications established specifically for New England.

Explanation of Provision

If a hospital can demonstrate to the Secretary that the area wage index applied to that hospital does not accurately reflect the actual labor market conditions faced by that hospital, based on criteria established by the Secretary (e.g. that the hospital must draw its employees from an area with a higher wage index), the Secretary shall, where he or she deems appropriate, make an adjustment in the hospital's payments, payable beginning with the next federal fiscal year. The provision would be subject to the limitations of budget neutrality for the years in which budget neutrality is applicable.

The Secretary of Health and Human Services would be directed to consult with the Secretary of Labor and the Commissioner of the Bureau of Labor Statistics to develop methods of refining and improving the adequacy and equity of the area wage index, specifically its applicability to hospital wages. The Secretary of HHS would be required to report to the Congress by May 1, 1984.

The wage index has been used by the Department of HHS for sometime in making adjustments to the section 223 cost reimbursement limits in effect prior to prospective payment. Questions have been raised in the past about the equity of the index. Those concerns have become more important with the enactment of prospective payment since the index actually affects the hospital's payment levels rather than just the cost limits.

The committee expects the Secretary of HHS to consult with the Commissioner of BLS to develop a more sound approach to the area wage index as it applies to all hospitals. For example, the current treatment of part-time employees under the index does not appear to be appropriate in its application to hospitals. The Committee believes that many of the problems cited by hospitals with respect to the index could be resolved for all hospitals rather than attempting to resolve problems with the index on a case-by-case basis.

In addition, however, the committee has required the Secretary to establish criteria under which hospitals can appeal the application of the index. Some hospitals argue, for example, that they are just outside an MSA area and must draw labor from the same market as those hospitals within the MSA. The Secretary may also wish to recognize, through such criteria that hospitals within an MSA area may have significant distinctions in their actual labor market experiences from that reflected in the index. In such cases, the Secretary would be authorized to make an adjustment in the hospital's wage index.

An adjustment in a hospital's payment as a result of an adjustment in the hospitals wage index would be made, effective with discharges occurring on or after October 1 following the determination. That is, the adjustment in the index would be effective with the next Federal fiscal year. This is to make the adjustment consistent with the update in the DRG payment at the beginning of each Federal fiscal year and to avoid the necessity of retrospective adjustments under a prospective system. Therefore any additional payments may be made no earlier than October 1, 1984.

Finally, the committee wishes to make it clear that any additional expenditure of medicare funds as a result of this provision will be subject to the limitations of budget neutrality for the years in which budget neutrality applies. Thereafter, the Secretary is expected to apply the provision in such a way as to take into account the overriding goal of reducing hospital costs and protecting the soundness of the medicare trust fund.

20. Definition of bona fide emergency services for purposes of limitations on payment for hospital outpatient services (sec. 1040 of the bill and sec. 1861 of the Act)

Present Law

The Budget Reconciliation Act of 1981 (P.L. 97-35) included a provision requiring the Secretary of HHS to place reasonable limits on hospital costs and physician charges for outpatient services. The limits were to be reasonably related to the charges for similar services in physician's offices in the area. The statute specifically exempted from the outpatient limits "bona fide emergency services provided in an emergency room."

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) included a provision to eliminate duplicate overhead payments for outpatient services. The provision added authority for the Secretary to reduce the payment to a physician providing services in an outpatient department by a factor representing the overhead costs already being paid by medicare through the payment to the hospital.

The Secretary of HHS issued regulations on October 1, 1982. The definition of "bona fide emergency services" was limited to services necessary to prevent death or serious impairment. After receiving comment, the Department of HHS reconsidered the definition. Although the regulations have not yet been reissued, it appears that the Department is prepared to broaden the definition.

Explanation of Provision

The bill would provide for the following statutory definition of "bona fide emergency services":

> Services provided in a hospital emergency room after the onset of a medical condition manifesting itself by symptoms of sufficient severity that the absence of immediate medical attention could reasonably be expected, by a prudent layperson possessing an average knowledge of health and medicine, to result in (a) placing the patient's health in jeopardy; (b) serious impairment to bodily functions; (c) serious dysfunction of any bodily organ or part; or (d) development or continuance of severe pain.

The committee believes that a statutory definition of "bona fide emergency services" is necessary to express clearly the intent of Congress in this regard.

21. Delay of effective date for single-rate for skilled nursing facilities (sec. 1041 of bill)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) required the Secretary to establish a single payment limit for both free-standing and hospital-based skilled nursing facilities (SNFs), effective October 1, 1982.

In the Social Security Amendments of 1983 (P.L. 98-21), the effective date was postponed for one year. In addition, the Congress required the Secretary to report by December 31, 1983 on the effect of the implementation of the TEFRA single-rate provision on hospital-based SFN's, given the difference (if any) in the patient populations served by such facilities and by freestanding SNF's. Further, the Secretary was required to report by the end of 1983 on the impact of hospital prospective payment on SNF's.

Explanation of Provision

The implementation of the single-rate for SNF's would be postponed until April 1, 1984. The committee believes it prudent to wait until the Secretary has completed her report on hospital-based SNF's before implementing the single-rate provision.

TITLE XI—TRADE ADJUSTMENT ASSISTANCE PROGRAMS

Title XI contains three amendments to the trade adjustment assistance (TAA) programs for workers and firms under the Trade Act of 1974, as amended under the Omnibus Budget Reconciliation Act of 1981. These programs were recently reauthorized for a two-year period until September 30, 1985, under Public Law 98-120. The amendments would become effective on the date on enactment of the bill.

A. Limitations on Trade Readjustment Allowances (Sec. 1101 of the Bill)

Present Law

Under present law, a worker certified eligible for trade adjustment assistance (TAA) benefits can receive up to 52 weeks of basic trade readjustment allowances (TRA) and unemployment compensation (UI) combined plus up to an additional 26 weeks of TRA if in training. Under section 233(a)(3) of the Trade Act of 1974 as amended in 1981, the additional 26 weeks of benefits can be collected only during the 26-week period immediately following the week the worker exhausts his entitlement to basic TRA benefits (i.e., the 52-week period after exhausting regular UI).

Reasons for Change

Because of delays in certification or delays in approval of training by State employment services, workers are often denied some or all of the extra 26 weeks of TRA by the time they can enter training. As a result, through no fault of their own, these workers may not be able to afford training. The amendment would remove this inequity.

Explanation of Provision

The bill (sec. 1101) amends section 233(a)(3) of the Trade Act to enable workers to receive the additional TRA benefits by beginning the 26-week collection period with the first week the worker is in training if that training has not been approved until after the last week of entitlement to basic TRA benefits. The present law would continue to apply in all cases not involving administrative delays in certifying workers or in approving their training.

B. Job Search and Relocation Allowances

Present Law

Under section 237 of the Trade Act, workers meeting certain eligibility requirements can be reimbursed for 90 percent of their necessary job search expenses up to a maximum of $600. Relocation allowances to eligible workers under section 238 of the Trade Act consist of 90 percent of reasonable and necessary expenses incurred in transporting a worker and his family and household effects, plus a lump sum payment of three times the worker's average weekly wage, up to a maximum of $600. These maximum limits were increased from $500 to $600 under the 1981 amendments to the program.

Reasons for Change

The purpose of increasing job search and relocation allowances is to reflect rising costs and to encourage greater worker mobility to reemployment opportunities which may exist beyond their present commuting distance.

Explanation of Provision

The bill (sec. 1102) amends section 237(a)(1) of the Trade Act to increase the maximum job search allowance from $600 to $800. The bill also amends section 238(d)(2) of that Act by increasing the maximum lump sum payment for relocation from $600 to $800.

C. Assistance to Industry (Sec. 1103 of the Bill)

Present Law

Section 265 of the Trade Act, added as part of the 1981 program amendments, authorizes the Secretary of Commerce to provide technical assistance on an industry-wide basis through existing agencies, private individuals, firms, universities, and institutions, and by grants, contracts, or agreements to trade associations, labor unions, or other nonprofit industry organizations whose membership includes a substantial number of firms who have been certified eligible to apply for TAA.

The focus of this program is different from the technical assistance available on a firm-by-firm basis. While technical assistance for an individual firm is furnished primarily to assist that firm in petitioning for TAA and/or in developing and carrying out its own economic adjustment plan, industry-wide technical assistance is designed to support new product development, new process development, export development, and other activities that enhance the future competitive position of entire industries in transition. Current law limits this kind of technical assistance, however, to $2,000,000 annually per industry.

Reasons for Change

Many workers within an industry may be certified as import impacted yet firms in the same industry chose not to petition for TAA or are not certified. The first amendment to section 265 would allow an industry to receive technical assistance if a substantial number of firms or workers have been certified.

Both changes are intended to make available technical assistance funds to basic industries where it can serve as "seed" money for research and development essential to the restructuring and revitalization of those basic industries.

Technical assistance for industry-wide programs for new product development, process development, export development, or other uses consistent with supporting an industry's adjustment to import competition should include those projects associated with next generation research and development. Such projects designed to improve significantly an industry's overall competitiveness and to ensure its future long-term viability should be given priority over programs that provide only marginal improvements in an industry's immediate competitive position.

Explanation of Provision

The bill (sec. 1103) amends section 265 of the Trade Act in two respects. Paragraph (1) amends section 265(a) to extend eligibility for industry-wide technical assistance to industries in which a substantial number of workers have been certified for trade adjustment assistance. Currently, an industry is eligible for technical assistance only if a substantial number of firms within that industry have been certified.

Paragraph (2) of section 1103 amends section 265(b) to increase from $2,000,000 to $10,000,000 the amount of assistance that can be provided annually to a single industry.

VI. BUDGET EFFECTS AND VOTE OF THE COMMITTEE

A. Committee Estimates

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on the budget by H.R. 4170, as reported by the committee. The committee agrees with the cost estimate regarding the spending (outlay) provisions (included in item B., below) prepared by the Congressional Budget Office based upon their most recent economic projections.

The table below summarizes the budget effects of the tax and other provisions in the bill for fiscal years 1984–1988. Separate revenue or budget estimates are shown in the text (Part V) for each title of the bill. Detailed estimates for the tax provisions are shown in Part IV (Revenue Effects) of this report.

SUMMARY BUDGET EFFECTS OF H.R. 4170

[In millions of dollars]

Item	Fiscal year				
	1984	1985	1986	1987	1988
Revenue effects of tax provisions (titles I-VIII)	2,307	2,330	3,433	5,178	7,127
Budget outlays:					
Social security disability provisions (title IX)	162	323	321	344	344
Medicare provisions (title X)	−261	−621	−1,093	−1,760	−2,602
Trade adjustment assistance provisions (title XI)	(1)	(1)	(1)	(1)	(1)
Total budget outlay effects	−99	−298	−772	−1,416	−2,258

(1) Less than $500,000.

The Office of the Actuary, Social Security Administration, has also estimated the impact of the disability amendments to Title II of the Social Security Act over a 75-year period. Under II-B economic assumptions, the disability trust fund remains in actuarial balance. (The estimates of the Office of the Actuary can be found below. Item c.)

B. Cost Estimate Prepared by the Congressional Budget Office

In compliance with 2(l)(3)(C) of rule XI, requiring a cost estimate prepared by the Congressional Budget Office, the following reports prepared by Congressional Budget Office are provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
WASHINGTON, D.C., *October 21, 1983.*

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has reviewed the revenue provisions of H.R. 4170, the Tax Reform Act of 1983, as reported by the Committee on Ways and Means. The bill provides for the simplification, improvement, and revision of major portions of the present tax system. The bill also provides for the improvement of the Social Security Disability system and the Medicare system.

The bill contains eleven titles. Titles IX through XI affect spending. A cost estimate of the spending provisions is being provided under separate cover. Titles I through VIII affect revenues. These titles are:

Title I—Tax Exempt Entity Leasing Provisions

Title I changes the tax treatment of property leased to foreigners, and to the federal government, state and local governments, and other tax-exempt entities. Among other stipulations, this title restricts the provision enacted in the Economic Recovery Tax Act of 1981 that permits the rehabilitation tax credit for property leased to tax-exempt institutions.

Title II—Life Insurance Tax Provisions

Title II provides new rules for the taxation of life insurance companies, replacing, among other things, the temporary life insurance provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982.

Title III—Private Foundation Provisions

Title III would modify rules, enacted principally in the Tax Reform Act of 1969, for the tax treatment of private foundations and charitable contributions to foundations.

Title IV—Simplication Provisions

Title IV would simplify rules in the tax law which affect many individual and business taxpayers. The provisions of this title address estimated income tax for individuals, domestic relations tax issues, investment tax credit at-risk rules, estate tax issues, foreign tax issues, the tax court, simplication of income tax credits, and certain obsolete provisions of the tax code.

Title V—Fringe Benefit Provisions

Title V would provide permanent rules for the taxation of fringe benefits. Under Title V, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes. A fringe benefit not excluded under this title or under another specific statutory provision is includable in gross income and subject to employment taxes at the excess of its fair market value over any amount paid by the employee for the benefit.

Title VI—Technical Corrections

Title VI contains technical, clerical, conforming, and clarifying amendments to provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revisions Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983, and other recently enacted tax legislation.

Title VII—Private Purpose Bond Provisions

Title VII extends the mortgage revenue bond program for five years to December 31, 1988; enables state and local governments to elect, for any year, to exchange all or part of their mortgage bond authority for authority to issue mortgage credit certificates; sets state-by-state per capita limits of $150 on the volume of industrial revenue and student loan bond issues, combined; and requires that all IRB-financed property, with the exception of multi-family housing, be depreciated using the straight-line method over the applicable Accelerated Cost Recovery System (ACRS) recovery period.

Title VIII—Miscellaneous Revenue Provisions

Title VIII addresses miscellaneous revenue matters, including capital gains treatment of condominium conversions, gifts made before March 31, 1983, disaster loss deductions, foreign investment companies, and money purchase pension plans.

H.R. 4170 eliminates some tax expenditures, and creates some new ones. On balance, H.R. 4170 would decrease the number of tax expenditure items in the tax code.

The CBO has reviewed the estimates of the revenue effects of the bill's tax provisions (Titles I through VIII) prepared by the staff of the Joint Committee on Taxation and concurs with the methods used by the Committee to estimate these revenue effects. When measured against the CBO revenue baseline, the revenue effects of Title II differ from those shown in Tables IV-1 and IV-2 of the conference report on the bill. The revenue effects of H.R. 4170, relative to CBO baseline revenues are shown in Table 1, attached.

Should the committee so desire, we would be pleased to provide further details on this estimate.

Sincerely,

RUDOLPH G. PENNER.

Table 1.—Revenue Effects of the Tax Reform Act of 1983

[Fiscal years, millions of dollars]

Provision	1984	1985	1986	1987	1988
Title I: Tax exempt entity leasing provisions	683	990	1,740	3,070	4,877
Title II: Life insurance tax provisions [1]	−252	−481	−553	−664	−756
Title III: Private foundation provisions	−13	−45	−46	−47	−50
Title IV: Simplification provisions	935	541	620	706	613
Title V: Fringe benefits provisions	(2)	(2)	(2)	(2)	(2)
Title VI: Technical corrections	(3)	(2)	(2)	(2)	(2)
Title VII: Private purpose bond provisions	6	80	328	620	829
Title VIII: Miscellaneous revenue provisions	−52	−55	3	41	67
Total revenue effect [1]	1,307	1,030	2,092	3,726	5,580

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[1] As noted in a footnote to Table IV-1 of the committee report on H.R. 4170, the estimates for Title II reflect a change in revenues relative to the level that would be generated under current tax law, which specifies that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) will expire at the end of 1983. The CBO revenue baseline assumes current tax law in this case and, therefore, includes the expiration of these temporary provisions on schedule. Relative to an alternative base that assumes that tax law would have been changed to extend these temporary provisions, the estimates would show increases in fiscal year receipts of $748 million in 1984, $819 million in 1985, $788 million in 1986, $788 million in 1987, and $791 million in 1988.

[2] Negligible.

[3] Loss of less than $10 million dollars.

U.S. Congress,
Congressional Budget Office,
Washington, D.C., October 21, 1983.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

Dear Mr. Chairman: Pursuant to Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has prepared the attached cost estimate for Titles IX, X, and XI of H.R. 4170, The Tax Reform Act of 1983, as ordered reported by the House Ways and Means Committee on October 19, 1983. Titles IX, X, and XI contain the spending provisions in H.R. 4170. An estimate of the revenue provisions in Titles I through VIII is being provided under separate cover.

Should the Committee so desire, we would be pleased to provide further details on this estimate.

Sincerely,

Rudolph G. Penner, *Director.*

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

1. Bill number: H.R. 4170.

2. Bill title: The Tax Reform Act of 1983.

3. Bill status: As ordered reported by the House Committee on Ways and Means, October 19, 1983.

4. Bill purpose: To provide for tax reform, and for other purposes.

5. Estimated cost to the Federal Government: This estimate is only for the spending provisions in H.R. 4170 in Titles IX, X, and XI. An estimate of the revenue provisions in Titles I through VIII is being provided under separate cover. The section below shows only the sections that have a budgetary impact.

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
Title IX:					
Budget authority	13	22	8	−10	−28
Outlays	162	323	321	344	344
Title X:					
Budget authority	−376	−683	−1,132	−1,811	−2,656
Outlays	−261	−621	−1,093	−1,760	−2,602
Title XI:					
Budget authority	(1)	(1)	(1)	(1)	(1)
Outlays	(1)	(1)	(1)	(1)	(1)
Total:					
Budget authority	−363	−661	−1,124	−1,821	−2,684
Outlays	−99	−298	−772	−1,416	−2,258

[1] Less than $500,000.

Basis of Estimate: The Title IX proposals that affect the Disability Insurance programs are shown below. Included on this table are the impacts of the Disability Insurance proposals on the Medicare, Medicaid, and Supplemental Security Income programs.

Title IX

[Outlays, by fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
Termination of benefits based on medical improvement (sec. 901):					
DI	26	65	90	115	115
HI and SMI	4	20	25	35	35
Medicaid	1	3	5	6	7
SSI	4	10	15	17	21
Multiple impairments (sec. 903):					
DI	1	4	7	11	13
HI and SMI	(1)	(1)	(1)	1	2
Medicaid	(1)	(1)	1	1	1

Title IX—Continued

[Outlays, by fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
SSI	(1)	1	2	2	3
Face-to-face evidentiary hearings for reviews (sec. 905):					
DI	0	11	11	8	6
SSI	0	3	3	3	3
Continued payment during appeal (sec. 906):					
DI	100	160	115	100	90
HI and SMI	35	60	50	40	35
Medical personnel qualifications (sec. 907):					
DI	2	7	14	23	25
HI and SMI	(1)	(1)	1	2	5
Medicaid	(1)	(1)	1	2	3
SSI	1	2	3	5	6
Compliance with court orders (sec. 910)	(2)	(2)	(2)	(2)	(2)
Vocational rehabilitation (sec. 911):					
DI	(1)	2	4	7	8
HI and SMI	(1)	(1)	(1)	(1)	(1)
SSI	(1)	(1)	(1)	(1)	(1)
Extension of secs. 1619a and 1619b:					
Medicaid	4	7	5	0	0
SSI	(1)	1	1	0	0
Total costs or savings:					
Budget authority	13	22	8	−10	−28
Estimated outlays [3]	162	323	321	344	344

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[1] Less than $500,000.

[2] The costs of this provision cannot be estimated because they depend on future court decisions.

[3] The details do not add to the totals due to interaction between provisions.

The following table shows the Title X proposals that affect the Medicare program. The table also includes the impact of the Medicare proposals on the Medicaid program.

Title X

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
Medicare (function 570):					
Clinical labs (sec. 1001): outlays	−150	−350	−425	−500	−600
Part B premiums (sec. 1002): outlays			−359	−967	−1,701
Hepatitis B vaccine (sec. 1003): outlays	2	−1	−2	−2	−4
Limitation on certain foot care: (sec. 1005): outlays	−28	−40	−42	−45	−48
Physician fee freeze (sec. 1007): outlays	−150	−350	−420	−480	−550
Hospital area wage index (sec. 1039): outlays			(1)	(1)	(1)
Delay single rate for SNFS (sec. 1041): outlays	10	20			
Impact of medicare changes on premiums: outlays	80	135	175	214	231
Medicaid (function 550):					
Impact of medicare changes on medicaid: outlays	−25	−35	−20	20	70
Total:					
Budget authority	−376	−683	−1,132	−1,811	−2,656
Outlays	−261	−621	−1,093	−1,760	−2,602

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[1] This proposal may have a budget impact in 1986 and in future years as the budget neutrality provision will no longer be in effect.

The Title XI proposals that affect Trade Adjustment Assistance are shown below.

Title XI

[By Fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
Trade adjustment assistance (functions 370, 500, and 600)					
Limitations on trade adjustment allowances (section 1101) outlays	(1)	(1)			
Job search and relocation allowances (section 1102) outlays	(1)	(1)			
Assistance to industry (section 1103) outlays					
Total					
Required budget authority/	(1)	(1)			
Authorization level	(1)	(1)			
Estimated outlays	(1)	(1)			

[1] Less than $500,000.

6. Estimated cost to State and local governments: The provisions in Title IX of this bill that affect SSI would increase expenditures of State and local governments. Their estimated net impact on State and local expenditures is less than $15 million a year.

The changes in SSI would increase State and local government costs because virtually all States supplement Federal SSI benefits. By making more persons eligible for SSI benefits, State costs would increase. States are also affected by the added outlays in Medicaid because States finance a portion of the program. The current State financing share is 46 percent.

There could be some offsets to these added SSI and Medicaid costs to the extent that persons made eligible for SSI by the bill might otherwise be eligible for general assistance or health care financed fully by States and localities. These potential offsets are not included in the cost estimate.

Several of the changes in Title X to Medicare would affect Medicaid spending since about 15 percent of those covered by Medicare are also covered by Medicaid. Changes in estimated State and local Medicaid spending are shown below.

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
Estimated changes in State and local spending in medicaid	−20	−30	−15	15	60

The clinical lab and physician fee freeze proposals would reduce Medicare expenditures to providers and save money in both the

Medicare and Medicaid programs. The increase in Part B premiums would result in an increase in Medicaid expenditures to those States that buy in to the Medicare program.

7. Estimate comparison: None.

8. Previous CBO estimate: On October 4, 1983, CBO provided a cost estimate for H.R. 3755, the Social Security Disability Benefits Reform Act of 1983. The provisions of H.R. 3755 are included in Title IX of H.R. 4170.

9. Estimate prepared by: Diane Burnside, Hinda Ripps Chaikind, Richard Hendrix, Kelly Lukins, Janice Peskin.

10. Estimate approved by Charles Seagram, for James L. Blum, Assistant Director for Budget Analysis.

C. Administration Estimate of Financial Impact of Title IX

The following tables, prepared by the Office of the Actuary, Social Security Administration, and the Department of Health and Human Services summarize the estimated long-range and short-range financial impact of Title IX of the bill.

Estimated Additional OASDI Benefit Payments Under Title IX of the Bill

[In millions]

Bill section	Provision	Fiscal year— 1984	1985	1986	1987	1988	Total 1984–88
901.	Medical improvement	$130	$280	$290	$310	$330	$1,340
902.	Study concerning evaluation of pain						
903.	Guidelines for disability determinations:						
	Multiple impairments	(1)	(1)	10	10	20	40
	Noncompetitive work	(1)	(1)	(1)	(1)	10	10
904.	Moratorium and revised criteria for mental impairment cases	(2)	(2)	(2)	(2)	(2)	(2)
905.	Face-to-face evidentiary hearing for CDI reviews		(1)	10	10	10	30
906.	Continuation of benefits through ALJ hearing	110	160	180	200	220	870
907.	Qualifications of certain medical professionals	(1)	10	10	20	20	60
908.	Regulatory standards for consultative exams	(1)	(1)	(1)	(1)	(1)	(1)
909.	Uniform standards for disability determinations	(1)	(1)	(1)	(1)	(1)	(1)
910.	Compliance with certain court orders	(3)	(3)	(3)	(3)	(3)	(3)
911.	Revision to vocational rehabilitation reimbursement rules	(1)	(1)	(1)	(1)	(1)	(1)
912.	Advisory Council and Trial work	(1)	(1)	(1)	(1)	(1)	(1)
913.	Staff attorneys						
	Work evaluation in mental impairment cases [4]	(1)	(1)	(1)	(1)	(1)	(1)
	Total	210	400	440	480	540	2,070

[1] Less than $5 million.

[2] No cost is shown for this provision since existing Administration initiatives are expected to accomplish the same results under present law. The financial effects of the initiatives are described in a memorandum by Richard S. Foster dated Aug. 1, 1983.

[3] This provision has the potential to affect benefit costs substantially, although such effects cannot be estimated since they would depend on unpredictable court cases and the subsequent actions of the court. As an example, if future court cases were to repeat past decisions concerning the evaluation of pain, additional benefits of over $1 billion could occur during 1984–88 as a result of this section.

[4] This item is contained in the committee report only, and is not associated with a particular section of the bill.

NOTES.—1. Due to the uncertainty concerning the effects of many of these proposals, actual experience could vary substantially from these estimates.

2. Estimates shown for each proposal generally exclude the effects of interaction with other proposals. Total costs for bill reflect such interactions.

3. Estimates are based on the alternative II–B assumptions of the 1983 Trustees Report.

Source: Social Security Administration, Offices of the Actuary, Sept. 29, 1983.

Estimated Cost of the Social Security Disability Provisions, Fiscal Years 1984–88

[In millions]

Provision	Fiscal year—					Total 1984–88
	1984	1985	1986	1987	1988	
OASDI benefit payments	$210	$410	$460	$500	$555	$2,135
OASDI administrative expenses	28	99	125	121	126	499
Medicare	50	105	145	175	205	680
Medicaid	7	13	18	23	28	89
SSI	2	9	14	18	24	68
Total	297	626	742	817	923	3,406

NOTE.—These estimates were made by the Office of the Actuary, Social Security Administration, based on the alternative II-B assumptions of the 1983 Trustees' Reports.

Source: Social Security Administration, Office of the Actuary, Oct. 20, 1983.

Estimated Long-Range Financial Impact of the Social Security Disability Provisions

Bill section	Provision	Change in long-range OASDI actuarial balance (as percent of taxable payroll)
901.	Standard of review for terminations of disability benefits	(1)
902.	Study concerning evaluation of pain	(1)
903.	Guidelines for disability determinations:	
	Multiple impairments	(1)
	Noncompetitive work	(1)
	Work evaluation in mental impairment cases [2]	(1)
904.	Moratorium and revised criteria for mental impairment cases	(3)
905.	Review procedure governing disability determinations affecting continued entitlement to disability benefits; demonstration projects relating to review of denials of disability benefit applications	(1)
906.	Continuation of benefits through ALJ decisions	−0.01
907.	Qualifications of medical professional evaluating mental impairments	(1)
908.	Regulatory standards for consultative examinations	(1)
909.	Administrative procedure and uniform standards	(1)
910.	Compliance with certain court orders	(1)
911.	Revision of vocational rehabilitation criteria	(1)
912.	Advisory Council on Medical Aspects of Disability	(1)
913.	Qualifying experience for appointment of certain staff attorneys to ALJ positions	(1)
	Total [4]	−0.02

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[1] Change in long-range OASDI actuarial balance is less than 0.005 percent of taxable payroll.

[2] Report language urges full "work evaluation" by a vocational expert in "borderline" mental impairment cases.

[3] The financial effect of this provision is attributed to the Secretary's initiative of June 7, 1983 for revising the criteria for evaluating mental impairment cases.

Illustrative estimates of the change in the long-range OASDI actuarial balance for this revision are −0.03, −0.07, and −0.15 percent of taxable payroll based on the assumption that 10 percent, 25 percent or 50 percent of current mental impairment denials would be allowed (slightly higher percentages are assumed for current CDI terminations). At this time it is not known what provisions would be made to these criteria.

[4] Total includes the effect of interaction among sections.

NOTE.—The estimates in this table are based on the alternative II-B assumptions of the 1983 Trustees Report.

Source: Social Security Administration, Office of the Actuary, Sept. 19, 1983.

D. Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill. The bill, H.R. 4170 was ordered favorably reported by voice vote.

VII. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clause 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 4170, as reported.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight responsibilities with respect to the Internal Revenue Code that caused it to conduct public hearings and assess the need for legislation in several areas of the tax law. In addition, continuing concern with cost control in the medicare program and administrative difficulties in defining and determining medical disability require constant revaluations of programs, their constituent elements and their administration. The committee also determined that there is a need to amend the trade adjustment assistance provisions certain provisions from previously reported H.R. 3391).

Details on the committee and subcommittee hearings and markup consideration of the various titles of the bill are contained in Part I.B. (Legislative Background) of the report. Following is a brief overview of the purposes of each of the 11 titles in the committee bill.

Eight titles of the bill relate to the Internal Revenue Code. Title I (Tax-Exempt Entity Leasing Act of 1983) deals with leasing, sale-leaseback, and analogous financial arrangements between the private and tax-exempt public and private organizations with respect to real and personal property. The activities that have attracted attention involved little or no economic substance and were motivated primarily by profitable financial manipulations to make available to tax-exempt entities some of the tax benefits ordinarily available to private profit-seeking organizations. The committee was lead by the evidence presented in public hearings to the conclusion that legislation was necessary to preclude further nonsubstantive extensions of tax incentives beyond the intended beneficiaries.

Title II (Life Insurance Tax Act of 1983) responds to the mandate in TEFRA to provide permanent solutions to problems in the tax treatment of the life insurance industry that were given temporary adjustments last year.

Title III (Revision of Private Foundation Provisions) makes adjustments in the tax treatment of private foundations, including charitable contributions to foundations. In addition, the excise tax on private foundation investment income is reduced in certain circumstances. These are changes made as part of the continuing oversight in this area.

In Title IV (Tax Law Simplification and Improvement Act of 1983), the income tax rules in many areas were modified in ways to simplify taxpayer compliance and administration without at the same time making substantive changes in the underlying policy in these areas. This included revisions of estimated tax payment provisions, domestic relations provisions, a reordering and rationalization of the various income tax credits, and other improvements in the tax law.

For the past 5 years, Congress has imposed a moratorium on the issuance by the Treasury Department of regulations that relate to the income tax treatment of nonstatutory fringe benefits, so that Congress could develop statutory rules in this area. In Title V of the bill (Permanent Tax Treatment of Fringe Benefits Act of 1983), the committee has provided specific statutory rules for the tax treatment of fringe benefits.

The Technical Corrections Act of 1983 (Title VI) contains necessary technical, clerical, conforming and clarifying amendments to provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983, and other recently enacted tax legislation.

Title VII (Tax-Exempt Bond Provisions) involves matters of urgent concern to Federal, State and local governments and many parts of the nongovernment community. The authority to issue qualified mortgage subsidy bonds expires at the end of 1983, and the committee had to act on the subject unless it intended to permit the authority to expire. In addition, the continuing expansion in the flow of private purpose tax-exempt revenue bonds has affected the structure and volume of activity in the tax-exempt bond market and has raised again the question about where to place limits on the issuance of private purpose tax-exempt revenue bonds.

Miscellaneous adjustments to tax provisions that did not fit into the other titles are in Title VIII of the bill.

Eligibility for disability benefits under the social security program is dealt with in Title IX (Social Security Disability Benefits Reform Act of 1983).

Title X contains amendments to the laws regarding certain health care costs under the medicare program. Three amendments were made to the Trade Adjustment Assistance Programs (Title XI), which recently was reauthorized.

Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing tax law by this bill involve the following changes in tax expenditures.

The overall thrust of the tax provisions is to reduce the amount of revenue that is not collected because of tax expenditure provisions. Tables in the section on overall revenue effects (Part IV., above) present detailed estimates of revenue effects of the tax expenditures. In Title I (leasing) of the bill, estimated tax expenditures are reduced by $658 million in fiscal year 1984 and $4,877 million in 1988, with a cumulative total during the 5-year period of $11.4 billion. The life insurance tax provisions (Title II) involve a net gain in revenue in each year of the 5-year period when measured from a base that assumes continuation of the 1982 changes. The provision for nondeductible IRAs (in Title II) is a new tax expenditure through the tax deferral on the interest earnings of the deposits. The life insurance provisions involve a restructuring of the tax provisions affecting the industry, and from the perspective of tax expenditures, the bill exchanges a larger number of tax expenditures for a smaller number. The overall effect of the new tax expenditures (of which the two most important are the special life insurance company deduction and the small life insurance company deduction) is a revenue gain of $3.9 billion in fiscal years 1984-1988.

The titles relating to private foundations, simplification provisions and technical corrections tend to be administrative in character and, even if a tax expenditure is added or expanded, negligible in the effect on net revenues. The fringe benefit provisions (Title V) do not result in increased tax expenditures because these provisions do not result in an overall revenue decrease.

Changes in the law relating to tax-exempt bonds (Title VII) will leave present law tax expenditures unchanged or bring about a reduction in the revenue loss from some industrial revenue bonds as the volume limitations will reduce the growth in issuance of IDBs. The 5-year extension of the mortgage subsidy bond provisions (as revised) will involve increased tax expenditures of $2.2 billion over the 5-year (1984–1988), but the revisions in the law will reduce what the tax expenditures would be otherwise if the current program were extended unchanged.

The provisions in title VIII (miscellaneous tax provisions) will involve some increases and decreases in tax expenditures; the amounts are shown in Part IV of the report.

Oversight by Committee on Government Operations

With respect to subdivision (D) of 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is expected to contribute to a modest decrease in inflationary pressures in the future by raising revenues (an estimated $20.4 billion over the 5-year period, fiscal years 1984-1988), which reduce the budget deficit and the consequent need of the Federal Government to borrow money in competition with the private sector. Further inflationary restraints will develop from the restriction on private purpose tax-exempt bonds because the businesses affected by the amendments will be required to compete for funds at the higher rates in the taxable money market. The restraints on public property leasing in Title I will redirect the use of otherwise investable funds to substantive economic projects that provide profit-making prospects which will increase both production and productivity.

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